Outward Bound:
Canadian Direct Investment in the United States

Alan M. Rugman

Canadian-American Committee

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Stephen C. Eyre

Adam H. Zimmerman

Co-chairmen of the Committee

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Contents

The Canadian-American Committee ..... inside front cover

Foreword by the Committee Co-chairmen vii

Acknowledgements ix

1 *Introduction: Canada as an Outward Investor* 1
The Significance of Direct Investment 1
The Reversal of Bilateral Direct Investment Flows 3
Investment Issues in Bilateral Economic Relations 8
Outline of the Study 9

2 *Economic Determinants of Canadian Outward Direct Investment* 10
Pull and Push Factors 11
The Attractiveness of the U.S. Market 12
Cross Investment by Multinationals 13
Internalization by Canadian Multinationals 17
International Diversification 19
Capital Markets and Canadian Direct Investment 20
Political Risk in Canada 26
Conclusion: Canada in a Global Economy 27

3 *Managerial Determinants of Canadian Outward Direct Investment* 28
The Canadian Multinationals 28
Motives for Canadian Foreign Direct Investment 31
Analysis of Transactions 38
Summary 41

4 *Policy Implications* 42
Costs and Benefits of Direct Investment 43
Canadian and U.S. Regulation of Foreign Investment 46
Trade and Investment Policy Linkages 53
Conclusion: Global Reality and Bilateral Economic Relations 56

Appendix A: Technical Issues in Data Measurement 59
Reconciling the Data on Direct Investment 59
A Comparison of Definitions for 1980 63
Retained Earnings 65

Appendix B: Statistical Tables 69

Tables
1 Canadian Foreign Direct Investment Flows, 1960–85 3
2 Bilateral Stocks of Foreign Direct Investment, Canada and the United States, 1975–85 4
3 U.S. Foreign Direct Investment Flows, 1975–85 6
4 Global Stocks of Foreign Direct Investment, United States, 1975–85 7
5 Foreign Direct Investment in the United States, 1984 14
6 Canada's Share of World Foreign Direct Investment Position in the United States by Sector, Year End 1984 15
7 Direct Investment Position of Canadian Real Estate in the United States, 1975–85 16
8 An Example of the Double Dip 22
9 Large Canadian Industrial Multinationals 29
10 Reasons for Investing in the United States: A Survey of 25 Small Canadian Companies 34
11 The Single Most Important Factor Influencing the Location Decision: A Survey of Canadian Firms, 1985 38
12 U.S. Inward Investment Transactions by Source Country, 1976–83 39
13 U.S. Inward Investment Transactions by Type, 1978–83 40
14 Canadian Affiliates in the United States: Selected Economic Data, 1982 44
15 Employment of Nonbank U.S. Affiliates, 1980–82 45

A-1 Canadian and U.S. Estimates of Canadian Direct Investment Position in the United States, 1975–85 60
A-2 Canadian and U.S. Estimates of Canadian Direct Investment Position in the United States, 1975–85, with Adjustments for Exchange Rates 62
A-3 Canadian and U.S. Methods Used to Define Foreign Direct Investment Stocks, 1980 63
A-4 Global Stock of Canadian Foreign Direct Investment by Type of Capital, 1975–82 64
A-5 Canadian Retained Earnings Abroad, 1980–82 65
A-6 Canadian Retained Earnings by Sector, 1980 66

A-7 Flows and Retained Earnings of Direct Investment to and from Canada 1960–85 67

B-1 Canadian Foreign Direct Investment Flows, 1927–59 71
B-2 Canadian Direct Investment Stock Abroad, by Area of Investment, 1975, 1980, and 1984 72
B-3 Canadian Investments in the United States, 1973–80 73
B-4 Canada's Balance of Payments, 1973–85 74
B-5 Distribution of Control of Capital in Canada's Nonfinancial Industries, 1974–82 75

Members of the Canadian-American Committee 77

The Canadian-American Committee's Sponsoring Organizations 82

Selected Publications of the Canadian-American Committee ..... inside back cover

Foreword

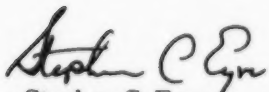
Most Canadians and a growing number of Americans are aware that our two countries are each other's largest trading partner. Few appreciate, however, the extent of the reciprocal investment ties linking our two economies.

Investment issues have long been a source of tensions in the bilateral relationship because of Canadian concerns about the extent of U.S. ownership of key Canadian industries. Although the United States is now a debtor country, U.S. corporations continue to have substantial operations throughout the world, with those in Canada accounting for more than one-quarter of all their holdings in the industrial countries.

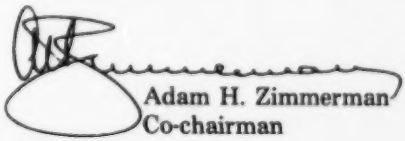
Over the past decade, however, there has been a remarkable shift in bilateral investment flows. Investment by Canadian firms in U.S. operations has accelerated and the stake of Canadian multinational enterprises in the U.S. economy has risen rapidly relative to the value of U.S. holdings in Canada. This study, by Alan M. Rugman of Dalhousie University in Halifax, documents the changes that have taken place.

In our interdependent economies, trade policies and laws can affect investment decisions, while investment policies can influence the pattern of trade. In the ongoing bilateral trade negotiations, one of Canada's goals is to obtain more secure access to the U.S. market in order to improve the investment climate in Canada. For its part, the United States seeks to ensure that Canadian investment policies do not impede U.S. exports to Canada. As the study indicates, the outcome of the negotiations will have a profound influence on the future pattern of bilateral trade and investment flows.

Publication of this study by the Canadian-American Committee does not imply that all of the Committee's members endorse the author's findings. The Committee undertook this study in an effort to promote better understanding of the investment dimension of the world's largest bilateral economic relationship.



Stephen C. Eyre
Co-chairman



Adam H. Zimmerman
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Halifax, Nova Scotia

1

Introduction: Canada as an Outward Investor

Economic interdependence is a fact of life in the late 1980s as massive flows of goods, services, and finance move among countries. Nowhere is this close linkage of domestic economies more evident than between Canada and the United States, the two countries sharing the largest bilateral trade flows and the largest reciprocal investments in the world.

When a multinational enterprise — defined as a firm with an operating subsidiary in at least one country other than its home base — makes a direct investment abroad, it can create new employment in and transfer technology to the host country. At the same time, direct investment inflows increase foreign ownership and control of the host economy.

Canadians have long been preoccupied with the high level of foreign ownership of firms within their borders, and the United States has been the dominant source of direct investment. During the past decade, however, outward investment by Canadian firms has increased so sharply that Canada is now a net exporter of investment. Yet this new trend has received little attention, even though it could have significant consequences for the Canadian-U.S. relationship. The objective of this study is to document and analyze this shift, focusing on investment in the United States by Canadian firms and on the causes and consequences of the change. This introductory chapter outlines the statistical phenomenon of the reversal of bilateral direct investment flows.

The Significance of Direct Investment

At the outset, it is important to distinguish between portfolio investment and direct investment. Portfolio investment is financial investment in which no control is exercised over the asset held. It consists of the acquisition of debt, such as government or corporate bonds, or equity securities held strictly for financial investment purposes. When such investment transfers savings between countries — that is, when a foreign individual or corporation holds the security — it may bear some risks but it is unlikely to have any significant influence on the structure or performance of individual industries.

Direct investment brings voting control over the management of a firm. Foreign direct investment means that the equity holders are in one coun-

try and the business operations are in another.[1] It usually entails a strategic commitment to the host country, since most such investments cannot be liquidated readily. The investor, usually a multinational enterprise, assumes the risks of particular business ventures and thus plays a distinctive role in the transfer of technology to the host country. Direct investment can become a significant influence because of its effects on the pattern of development of particular industries in the host economy and on overall levels of employment and international trade.

The economic distinction between portfolio and foreign direct investment can be important. Both are vehicles for transferring savings from one country to another, but direct investment flows are small relative to portfolio capital flows, which can easily offset them. In the late 1970s, for example, Canada was a net exporter of direct investment, yet at the same time it was experiencing large current-account deficits and substantial net capital inflows.

The distinction between direct and portfolio investments also has a political dimension because the former can result in foreign ownership and control of major enterprises in the host economy. The issue of foreign control of industry has been a particularly sensitive one in Canada, which has levels of foreign ownership that are much higher than those in any other industrial country. Moreover, that ownership is heavily concentrated in the hands of U.S. corporations.

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[1]Foreign direct investment usually takes the form of equity capital, which is most often acquired by the purchase of shares resulting in the ownership of incorporated foreign subsidiaries. Also included in foreign direct investment are the net assets of unincorporated branches plus loans from parents to subsidiaries and affiliates. Both the U.S. and Canadian statistics on foreign investment use 10 percent ownership as a benchmark for effective control in a business enterprise. The U.S. Department of Commerce reports data on direct investment in its monthly *Survey of Current Business*, defining a U.S. affiliate as "a U.S. business enterprise in which one foreign person owns, directly or indirectly, 10 percent or more of the voting securities, or the equivalent" (R. David Belli, "Foreign Direct Investment in the United States in 1983," *Survey of Current Business* [October 1984], p. 26). Similarly, Statistics Canada (*Canada's International Investment Position: 1979 and 1980*, Cat. no. 67-202 [Ottawa, 1984], pp. 19–20) defines Canadian direct investment abroad as:

> the book value, at a point in time, of long-term capital owned by Canadian direct investors in foreign subsidiaries, affiliates, and branches. . . . This investment is normally identified by ownership of at least 10 percent of the equity of the foreign concern. Direct investment covers the long-term capital provided by or accruing to Canadian direct investors, comprising both long-term debt (bonds, debentures, loans, advances, etc.) and equity (common and preferred shares, and retained earnings).

Such a 10 percent criterion should be interpreted with caution to avoid some odd results; for example, some readers will be interested to learn that the U.S. Department of Commerce would consider Du Pont to be foreign owned since more than 20 percent of its stock is now owned by Seagram, the Canadian multinational enterprise.

Table 1
Canadian Foreign Direct Investment Flows, 1960–85[a]
(Can.$ millions)

	Foreign direct investment in Canada[b]	Canadian foreign direct investment abroad	Net flow (1) + (2)
	(1)	(2)	(3)
1960	$670	$–50	$620
1961	560	–80	480
1962	505	–105	400
1963	280	–135	145
1964	270	–95	175
1965	535	–125	410
1966	790	–5	785
1967	691	–125	566
1968	590	–225	365
1969	720	–370	350
1970	905	–315	590
1971	925	–230	695
1972	620	–400	220
1973	830	–770	60
1974	845	–810	35
1975	725	–915	–190
1976	–300	–590	–890
1977	475	–740	–265
1978	135	–2,325	–2,190
1979	750	–2,550	–1,800
1980	800	–3,150	–2,350
1981	–4,400	–6,900	–11,300
1982	–1,000	–1,075	–2,075
1983	200	–3,226	–3,026
1984	1,698	–3,300	–1,602
1985	–2,950	–5,100	–7,850

[a]Data exclude reinvested earnings (see text, note 3). A minus sign indicates an outflow of capital from Canada — an increase in holdings of assets abroad or a reduction in liabilities to nonresidents.

[b]Column 1 represents gross inflows minus gross outflows, including acquisitions of foreign direct investment in Canada by nonresidents. A similar interpretation applies to Canadian foreign direct investment in column 2.

Source: Statistics Canada, *Quarterly Estimates of the Canadian Balance of International Payments*, Cat. no. 67-001, Table 40, various issues. Data from 1982–85 revised in September 1986.

The Reversal of Bilateral Direct Investment Flows

Canada's reliance on foreign direct investment has helped to finance a faster rate of economic development than it could have expected from domestic savings alone. But, as Table 1 portrays, a reversal in Canada's position as an importer of direct investment has been under way since 1975.

Table 2
Bilateral Stocks of Foreign Direct Investment, Canada and the United States, 1975–85
(Can.$ millions)

	Canadian position in the U.S.	U.S. position in Canada	Net position (1) – (2)	(1) / (2) (%)
	(1)	(2)	(3)	(4)
1975	$5,559	$29,666	$–24,107	18.7%
1976	6,092	31,917	–25,825	19.1
1977	7,116	34,720	–27,604	20.5
1978	8,965	38,352	–29,387	23.4
1979	12,063	42,775	–30,708	28.4
1980	16,386	48,686	–32,298	33.7
1981	21,831	52,123	–30,292	41.9
1982	23,137	52,640	–29,503	44.0
1983	25,528	56,390	–30,862	45.3
1984	29,932	62,359	–32,427	50.0
1985	35,474	63,375	–27,901	60.0
Average rate of increase 1975–85	20.3%	7.2%		

Source: Statistics Canada, *Canada's International Investment Position 1979 and 1980*, Cat. no. 67-202 (Ottawa, 1984), Tables 2 and 18. Data for 1981–84 supplied by Statistics Canada, International and Financial Economics Division.

Between 1960 and 1974, net investment into the country averaged about $390 million per year.[2] Since 1975, net investment has been outward, averaging more than seven times this figure — about $3 billion a year.[3] Only during the depression years, from 1932 to 1939, has such a reversal occurred in the past (see Table B-1 in Appendix B).

The current shift in capital flows might be attributed partly to foreign firms' declining interest in investing in Canada. In contrast to the trend of steadily expanding foreign direct investment inflows before 1976, evident in Table 1, foreign investment has faltered in several recent years. In 1976, during the 1981–82 period, and again in 1985, U.S. and other foreign firms divested more assets in Canada than they acquired. However, the net repatriation of foreign capital from Canada has been confined to those four years. In most years since 1976, foreign firms have continued to invest in Canada, although perhaps on a smaller scale than before.

[2]All dollar amounts in the text refer to Canadian dollars unless otherwise noted.
[3]The data in Table 1 are taken from the quarterly balance of payment statistics, which exclude data on reinvested earnings. All subsequent tables include reinvested earnings, which are an important source of Canadian foreign direct investment, having accounted for about 31 percent of additions to the stock of such investment during the 1975–82 period. See Appendix A, especially Table A-7.

A much more significant factor in the shift of net investment flows has been Canadian firms' outward direct investment, which started to accelerate in the mid-1970s. Since 1978, Canadian outward investment has averaged about $3.5 billion, with notable outflows in 1981 and 1985 when Canadian firms spent more than $5.0 billion acquiring assets in other countries.

Canada's New Investment Position

This upsurge of Canadian outward direct investment flows has been spectacular, and the United States has been the recipient of most recent Canadian outflows — some 57 percent of it on average during the 1975–84 period, about 60 percent in 1983, and more than 65 percent in 1984.[4] In 1973, the holdings of Canadian firms in the United States amounted to one-tenth of the value of U.S. investment in Canada. A decade later the ratio reached one-half.

The reversal in Canadian direct investment is confirmed by analysis of stock figures on Canada's investment position, as shown in Table 2.[5] Column 1 reveals that the book value of Canada's direct investment in the United States doubled in six years, up to $35 billion by 1985. The average annual rate of increase was about 20 percent over the decade. As shown in column 2, U.S. direct investment in Canada also increased during this period, but the value of the stock rose at a much smaller rate, about 7 percent per year, despite the larger retained earnings base of U.S. corporations in Canada.

The net Canadian position in the United States as a percentage of the U.S. position in Canada (column 4) has shown a remarkable change, from 18.7 percent in 1975 to 28.4 percent in 1979 and to 60 percent in 1985. Considering the data from the U.S. viewpoint — that is, the inverse of each figure in column 4 — one would find that the ratio of U.S. to Canadian direct investment fell so sharply during the 1979–85 period that it had more than halved by the end of the 11 years considered in Table 2. Even if one makes allowance for the greater age of the U.S. stock and thus its greater undervaluation in these book value measures, compared to its real

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[4]In terms of stock data, Canadian direct investment in the United States as a percentage of total Canadian direct investment abroad increased from just under 53 percent in 1975 to 63 percent in 1980 and to 72 percent in 1984 (see Table B-2 in Appendix B).

[5]A potential source of confusion in the use of statistics on direct investment is the necessity of distinguishing between stock and flow concepts. At any point in time there is a stock of accumulated direct investment; this is the book value of historical flows of direct investment. A flow relates to a specific period of time — usually a year but sometimes a quarter or month — and it reflects a change in the magnitude of direct investment over that period. An increase in the net flows of Canadian direct investment into the United States over a year leads to an increase in the book value of the stock of Canadian direct investment.

Since the flows in Table 1 do not include reinvested earnings, it is impossible to reconcile them with the changes in the stock of direct investment reported in Table 2.

Table 3
U.S. Foreign Direct Investment Flows, 1975–85[a]
(U.S.$ millions)

	Foreign direct investment in the United States	U.S. foreign direct investment abroad	Net flow (1) + (2)
	(1)	(2)	(3)
1975	$2,437	$−6,307	$−3,870
1976	2,176	−4,596	−2,420
1977	3,338	−12,215	−8,887
1978	6,294	−16,670	−10,376
1979	9,713	−24,319	−14,606
1980	16,918	−18,546	−1,628
1981	25,195	−8,691	16,504
1982	13,792	−2,369	11,423
1983	11,946	373	12,319
1984	25,359	3,858	29,217
1985	17,856	18,752	36,608

[a]Foreign direct investment is defined here as ownership of at least 10 percent of a firm's voting securities or equivalent by a single investor whose country is not that of the firm. A minus sign indicates a flow out of the United States. Data include retained earnings in each year.

Source: *Survey of Current Business* (U.S. Department of Commerce), various issues.

market value,[6] it is apparent that the turnaround in Canada's direct investment picture, starting in 1975 and accelerating after 1979, is a major phenomenon worthy of detailed study.

The United States: From Capital Exporter to Capital Importer

The United States was the financial engine for postwar development of the world economy. It is still the world's largest home country for foreign direct investment, and U.S. multinationals are still spread around most countries of the world, including Canada.[7] Yet today, the United States

[6]In a period of rapid inflation, the book values of stocks of foreign direct investment seriously understate their actual values; the accumulated book value of investments made in the past is less than the current replacement value of these assets. Since most Canadian direct investment in the United States is fairly new, with more than half of it having occurred in the past five years, this undervaluation of Canadian wealth is not such a serious problem in Table 2 as is the undervaluation of U.S. foreign direct investment in Canada, most of which occurred in earlier periods. For more detail, refer to Appendix A.

[7]For previous analyses of foreign direct investment in the United States, see Simon Webley, *Foreign Direct Investment in the United States: Opportunities and Impediments*, BNAC 15 (London: British-North American Committee, 1974); and Jeff S. Arpan and David Ricks, "Foreign Direct Investment in the United States and Some Attendant Research Problems," *Journal of International Business Studies* 5 (1974): 1–7. A more recent general study, building on the modern theory of the multinational enterprise and containing several national case studies of inward direct investment into the United States, is Peter Gray, ed., *Uncle Sam as Host: Foreign Direct Investment in the United States: Research in International Business*

(continued)

Table 4
Global Stocks of Foreign Direct Investment, United States, 1975–85

	U.S. investment abroad	Foreign direct investment in the U.S.	Net (1 – 2)	(1 / 2)	(2 / 1)
	(U.S.$ millions)			Percentage	
	(1)	(2)	(3)	(4)	(5)
1975	$124,050	$27,662	$96,388	448.4%	22.3%
1976	136,809	30,770	106,039	444.6	22.5
1977	145,990	34,595	111,395	422.0	23.7
1978	162,727	42,471	120,256	383.1	26.1
1979	187,858	54,462	133,396	344.9	29.0
1980	215,375	83,046	132,329	259.3	38.6
1981	228,348	108,714	119,634	210.0	47.6
1982	207,752	124,667	82,536	166.6	60.0
1983	207,203	137,061	70,142	151.2	66.1
1984	212,994	164,583	48,411	129.4	77.3
1985	232,667	182,951	49,716	127.2	78.6
Average rate of increase 1975–85	8.6%	21.4%			

Source: *Survey of Current Business* (U.S. Department of Commerce), various issues.

has also become the world's largest host country for foreign direct investment.

Table 3 shows direct investment flows for the United States over the past decade. Until 1980, the United States was a large net capital exporter of direct investment, with net outflows averaging about U.S.$8 billion a year. In 1981, a strong reversal occurred. Since that time, the United States has been a large net importer of foreign direct investment, with net inflows averaging U.S.$21 billion a year.

A similar pattern shows up in Table 4, which reports data on the stocks of U.S. foreign direct investment. The U.S. position deteriorated from a net surplus of more than U.S.$133 billion in 1979 to less than one-half that amount by 1985. The erosion resulted primarily from the massive inflows of foreign direct investment since 1980, with the inward stock more than doubling from U.S.$83 billion to U.S.$183 billion.[8] This decline in the U.S.

[7]Continued . . .
and Finance, vol. 5 (Greenwich, Conn.: JAI Press, 1986). None of these studies pays particular attention to Canada.

[8]One-half of the direct investment into the United States from all countries took place between 1981 and 1985, but only 20 percent of the *stock* of foreign direct investment there was added during this recent period. From the contrast in these statistics, it is apparent that the market value of the stock is much greater than its recorded book value. One conclusion is that the United States is in a stronger financial position than is indicated by the shift in its net international investment position from a surplus of over U.S.$100 billion in 1981 to about U.S.$50 billion by 1985.

net stock of foreign direct investment parallels the United States' overall shift from being the world's largest creditor to being its largest debtor.

Canada has played its part in this rundown of the U.S. net stock of direct investment. In so doing, it has been participating in a shift in international economic and financial relationships that is largely unrecognized but of profound importance to both world politics and the bilateral relationship.

Investment Issues in Bilateral Economic Relations

Foreign direct investment is one aspect of the entire economic relationship between Canada and the United States, a relationship that is asymmetric in terms of the relative size and degree of openness of the two economies. The GNP of the United States is 12 times that of Canada, but international trade accounts for only 10 percent of U.S. GNP compared with about 30 percent of Canada's. An even more striking asymmetry is the relative importance of trade between the two countries. In 1985, almost four-fifths of Canadian exports went to the United States, while Canada purchased only one-quarter of U.S. exports.

Asymmetry is also evident in foreign direct investment in the two economies. For the past half-century, about four-fifths of such investment in Canada has come from the United States, equaling about 15 percent of Canada's GNP in 1981. For the United States, in contrast, outside ownership remains an almost trivial matter; in 1981, foreign direct investment in the United States was only 3 percent of its GNP, and the Canadian component of this investment was just was 0.4 percent of U.S. GNP. Thus, for the United States, Canadian direct investment influences only a very small portion of the economy, whereas for Canada, U.S. capital inflows can have a significant effect, and inward investment is a sensitive matter economically, culturally, and politically. At present, policy issues involving foreign ownership are clearly of greater importance to Canada than they are to the United States, although this situation may be changing with the reduction of U.S. control in Canada.[9]

Given the asymmetry of the two economies, it is not surprising that investment issues have been a source of friction in the two countries' bilateral relations. Canadian policies toward foreign direct investment, conditioned by the nature and extent of U.S. ownership of the economy, have been ambivalent. Canadian governments have encouraged foreign direct investment while expressing concern about the performance of foreign-controlled firms

[9]Data on foreign ownership and control of Canadian industry appear in Appendix B, Table B-5. Overall, the amount of foreign control in Canada has been steadily decreasing. In 1974, the figure for all foreign control in all Canadian industry was 33 percent (of which U.S. control was 26 percent); by 1982, the overall figure had fallen to 26 percent (U.S. control, 20 percent). There are significant variations by sector; for example, the financial, railway, and utilities sectors have virtually no foreign control, whereas foreign control of the petroleum and natural gas sector in 1982 was 45 percent (U.S. control, 35 percent), down from 75 percent (U.S. control, 58 percent) in 1974.

and establishing such major bilateral irritants as the Foreign Investment Review Agency and the National Energy Program.[10] Negotiating the bilateral tax treaty was protracted and difficult mostly because of differences in investment policy.[11] The substantial reversal of direct investment flows over the past decade has gone largely unnoticed, and its policy implications have not been explored.

Outline of the Study

This study is an examination of the new trend in investment flows and its implications for Canadian-U.S. relations. Chapter 2 examines economic factors influencing direct investment flows between the two countries. It identifies a set of pull and push factors and relates them to the empirical evidence in order to assess their importance. The objective is to identify the economic and policy developments in both countries that have contributed to the reversal of flows.

Following consideration of these economy-wide influences, Chapter 3 focuses on the investment decisions made by the managers of Canadian multinational enterprises. It analyzes survey evidence about the determinants of these decisions, and reviews the recent performance of major Canadian multinationals.

The final chapter explores the policy aspects of the reversal of direct investment flows. It considers the implications for future bilateral economic relations and how investment issues are related to the outcome of the current bilateral trade negotiations.

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[10]For a discussion of the National Energy Program, see David Leyton-Brown, *Weathering the Storm: Canadian-U.S. Relations, 1980–83*, CAC 51 (Toronto; Washington, D.C.: Canadian-American Committee, 1985), Chapter 3.

[11]For a discussion of tax issues, see R.M. Bird and D.J.S. Brean, "Canada-U.S. Tax Relations: Issues and Perspectives," in J. Whalley, ed., *U.S.-Canada Trade and Investment Frictions* (Toronto: Ontario Economic Council, 1985), pp. 391–425.

2

Economic Determinants of Canadian Outward Direct Investment

What are the economic motives for Canadian direct investment in the United States? This chapter discusses the economic factors that are broad, aggregate determinants of direct investment. They complement managerial determinants, which may be unique to specific firms, and are best understood by analysis of the particular decisions of Canadian firms, as is undertaken in the next chapter. A key theme in this study is the need to recognize the managerial focus of decisions about foreign direct investment. Although underlying economic and financial variables and government regulations play their part, the actual decision to invest in the United States is made by the individual Canadian enterprise. Its managers plan in response to their evaluation of relevant economic, financial, and environmental — especially governmental — factors. The art of strategic management is to make investment decisions in the face of incomplete information. (In the Canadian-U.S. context, perhaps the source of greatest uncertainty is changing government policy.)

Bearing this in mind, this chapter explores two major economic determinants of Canadian outward direct investment. The first is the need to maintain access to the U.S. market. When this access is threatened by tariff or nontariff barriers, a Canadian firm is likely to turn to direct investment as an alternative to exporting. In this manner, it is responding to environmental conditions broadly set by government policies. Foreign investment also takes place when foreign sales incur information or other types of "natural" transaction costs; the Canadian firm establishes plants in the United States to reduce such costs by local contact and familiarity with customers' wishes. State and federal investment incentives supplement the benefits of control provided through a multinational firm's internal markets and help to offset the increased risk of establishing operations abroad. (Corporations trade within the firm through internal markets in order to maintain control over a firm-specific advantage, such as familiarity with proprietary technology.)

The second determinant is the ability of Canadian firms to go abroad from a solid domestic base. Also, Canadian financial and economic institutions have matured to the extent that they match those of other leading industrialized countries. For example, Canada's banks are able to supply services and support to expanding Canadian multinationals.

Canadian direct investment in the United States is part of a secular trend whereby firms are going abroad as part of overall strategic planning in which diversification and product line expansion is a method to strengthen existing businesses.

Against this background, managerial decisions effectively integrate many influences.

Pull and Push Factors

Analysis of the economic determinants of Canadian foreign direct investment in the United States can be facilitated by dividing the factors into pulls from the United States and pushes from within Canada.

Pull factors attract or encourage Canadian firms to make direct investments south of the border. In general, they are market and policy factors originating in the United States. They may include: the relatively greater size and diversity of the U.S. market; the recent escalation of nontariff barriers to trade, which encourage Canadian firms to substitute direct investment for exports; political risk perceived to be lower in the United States than in Canada; greater productivity and cheaper factor costs relative to Canada's; investment incentives (often given by local and state governments in the United States); and the opportunity to customize products and identify niches for successful marketing.

Push factors, on the other hand, come from Canadian markets and policies. They encourage firms to make direct investments abroad in order to maintain or enhance a competitive position. They may include: differential costs for factors such as labor and capital; tax and related policies affecting the investment climate; economic regulations and other government-related cost factors; and the increasing ability of the maturing Canadian managerial and economic system to support outward investment.

Although one must remember that these factors do not operate in isolation from each other, pull factors may be thought of as market-driven determinants of foreign direct investment, while push factors are primarily determinants of portfolio investment that may have secondary effects on direct investment. Push factors are particularly sensitive to government policy changes in response to macroeconomic events, especially in the tax and fiscal area, and to changes in capital markets induced by new regulations and other government policies. The market-driven pull factors are less sensitive to government policy changes, with the exception of trade policy, which may influence a firm's choice among exporting, licensing, or directly investing abroad.

Of course, the distinction between push and pull factors is merely a device to highlight the potential determinants of Canadian outward direct investment. In reality, the economic interdependence of Canada and the

United States means the two sets of factors are related. Indeed, many of them are of a relative nature. And from the viewpoint of the managers of Canadian multinational enterprises, decisions about entry into the U.S. market have to be made on the basis of judgments about all the factors in combination. From the viewpoint of U.S. and Canadian policymakers, however, it is useful to attempt to distinguish the policy factors controlled by each country and to assess their importance relative to international market factors outside the control of governments.

The Attractiveness of the U.S. Market

Canadian firms selling in a domestic market of 25 million people frequently find that opportunities for expansion are limited. For some product lines economies of scale are not available until the firm seeks out foreign markets. The nearest available market is the United States, so many Canadian-based firms expand their sales through exporting there. As their familiarity with the U.S. market increases and expansion continues, these firms may begin to develop subsidiary production in the United States, thereby becoming multinational enterprises. This process is accelerated by the presence of additional reasons for choosing subsidiary production rather than exporting, such as an increase in U.S. nontariff barriers to trade or an increase in U.S. investment incentives.

There is, in practice, a long list of supporting explanations for Canadian business activity south of the border. A cash-rich Canadian firm may seek out acquisitions in the United States as a means of strategic diversification; the United States may be viewed as a safe place for direct investment because it is perceived to have less political risk or better relative factor costs than Canada in feasible alternative locations; in periods of depreciation of the U.S. dollar against the Canadian dollar — a situation rarely observed in the past ten years — Canadians may find U.S. assets relatively cheap; various U.S. federal, state, and municipal investment incentives may attract direct investment; and so on.

Underlying all these explanations — indeed, a precondition for most of them — is the sheer size and diversity of the U.S. market. The opportunities for expansion of product lines and services in the large and wealthy U.S. economy are a great attraction. Canadian firms benefit from a tremendous locational advantage, being situated next door to the world's richest economy. During the past ten years, the inevitable consequence has been an ever-increasing concentration on the U.S. market, at the expense of diversification across the Atlantic or Pacific. Now, nearly four-fifths of Canada's trade and some two-thirds of its foreign direct investment is with the United States.

Compounding this natural trend for Canadian firms to look south is the recent emergence of the United States as the world's primary recipient

of direct investment. Multinationals, not only from Canada but from all the industrialized countries, are attracted to the United States, where they are finding markets that afford excellent opportunities for product line expansion and diversification.

In brief, perhaps the most important pull factor attracting Canadian direct investment into the United States is the size and diversity of the U.S. market, a factor that also attracts investment by firms from other countries.

Cross Investments by Multinationals

The recent large increase in foreign direct investment by Canadian firms is part of a global phenomenon. The world's largest multinational enterprises increasingly are engaged in cross investments in each other's countries. European and Japanese firms are investing in the United States at a rapid pace. The Japanese are also penetrating European markets, using foreign direct investment in the United Kingdom as a base. U.S. multinationals continue to invest in Canada, Europe, and the newly industrialized countries of Southeast Asia. U.S. firms are also becoming aggressive in their attempts to operate in Japan, as are European multinationals.[1]

There are basically three reasons for such cross investment. First, a firm can enjoy economies of scale by operating production facilities in more than one country while using an integrated system of strategic planning to monitor and control output for a variety of worldwide markets. Second, cross investment increases opportunities for product differentiation; it becomes feasible for a multinational enterprise to target specific market niches in different countries and to supply them efficiently through centralized planning of production and distribution. Third, consumer tastes around the world are converging, leading to opportunities for large multinational firms to design products and services for global markets.[2]

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[1]This phenomenon of cross investments by multinationals in each other's home markets is called intra-industry foreign direct investment. It has been examined both theoretically and empirically in a recent National Science Foundation volume: Asim Erdilek, ed., *Multinationals as Mutual Invaders: Intra-Industry Direct Foreign Investment* (London: Croom Helm, 1985). In general, the contributors to this study see such intra-industry investment as a natural evolution of international economic activity and a complement to the increasing degree of intra-industry trade. Such two-way cross investments are required for multinationals to acquire economies of scale and of scope. (The latter occur when unit-cost and price reductions accompany output increases of closely related product lines, produced by subassemblies and customized by marketing intelligence.)

Cross investments are also likely to occur between countries with similar factor endowments. See Herbert G. Grubel and Peter J. Lloyd, *Intra-Industry Trade: The Theory and Measurement of International Trade in Differentiated Products* (London: Macmillan, 1975).

[2]For a more complete explanation of this analysis, see Alan M. Rugman, "The Determinants of Intra-Industry Direct Foreign Investment," in Erdilek, ed., *Multinationals as Mutual Invaders*, pp. 38–59.

Table 5
Foreign Direct Investment in the United States, 1984

	Value at year end	
	U.S.$ millions	Percentage
Canada[a]	$14,001	8.8%
France	6,502	4.1
West Germany	11,956	7.5
United Kingdom	38,099	23.9
Netherlands	32,643	20.5
Other European Community	5,649	3.5
Other Europe	11,718	7.3
Total Europe	106,567	66.8
Japan	14,817	9.3
South and Central America	2,804	1.7
Netherlands Antilles	10,523	6.6
Other Latin America	2,188	1.4
Total Latin America	15,515	9.7
Middle East	5,159	3.2
Australia, New Zealand, South Africa	2,366	1.5
Other Africa, Asia, and Pacific	1,146	0.7
Total rest of world	8,671	5.4
OPEC (part of above)	4,725	3.0
Total	*159,571*	

[a]If the Statistics Canada data in Table 2 were converted into U.S. dollars and used here, Canadian foreign direct investment in the United States would be listed as $22,652 or 14.2 percent of the total. See Appendix A for an explanation of this discrepancy.

Sources: *Survey of Current Business* (U.S. Department of Commerce), various issues; U.S. Department of Commerce, *News*, BEA 85-33, Washington, D.C., June 1985.

All three reasons give the multinational enterprise incentives to build a local presence in each of its markets. It may choose nonequity forms of participation to achieve this presence for some product lines and in some countries, but the usual method is control of a wholly-owned producing subsidiary.

Canada as One of a Family of Investors in the United States

The hub of this global multinational activity is the United States, which is now simultaneously the world's largest home and host country to direct investment. The bilateral nature of Canadian-U.S. direct investment must be reviewed against the leading role the United States plays in the worldwide spread of cross investment.

Table 6
Canada's Share of World Foreign Direct Investment Position in the United States by Sector, Year End 1984

Sector	Canada	World	(1)/(2)	Sectoral breakdown Canada	World
	(U.S.$ millions)			(Percentage)	
	(1)	(2)	(3)	(4)	(5)
Manufacturing	$3,888	$50,664	7.7%	27.8%	31.8%
Trade	1,651	30,494	5.4	11.8	19.1
Finance, except banking	547	4,246	12.9	3.9	2.7
Banking	1,093	10,203	10.7	7.8	6.4
Insurance	982	8,819	11.1	7.0	5.5
Real estate	2,717	16,899	16.1	19.4	10.6
Petroleum	1,419	24,916	5.7	10.1	15.6
Other	1,703	13,329	12.8	12.2	8.3
All industries	*14,001*	*159,571*	*8.8*	*100.0*	*100.0*

Sources: *Survey of Current Business* (U.S. Department of Commerce), October 1977; U.S. Department of Commerce, *News*, BEA 85-33, Washington, D.C., June 1985.

The best available data for doing so are from the U.S. Department of Commerce.[3] They suggest that Canadian foreign direct investment in the United States is reflective of the global investment patterns of the 1980s, with substantial growth resembling that of several leading industrialized countries. As shown in Table 5, Canada has become the fourth-largest investor in the United States, holding almost one-tenth of its foreign-owned capital stock in 1984. Ahead of Canada are the United Kingdom, which recently has accounted for about one-quarter of annual investments; the Netherlands, which provides about one-fifth (some of which are disguised tax-haven funds); and Japan, whose direct investment in the United States has increased greatly in the past few years and will probably do so in the future at an even faster rate. West Germany's investment is also on the rise, standing in 1984 at roughly the same level as that of Japan and Canada. There have also been increases in direct investment from the members of the Organization of Petroleum Exporting Countries and from the Middle East; both groupings are now at about 3 percent of the total.

[3]Unfortunately, the department's balance of payments statistics do not identify an investment's ultimate beneficial owner (although data from the department's balance sheet survey does so). Thus, the U.S. data tend to understate the extent of involvement — probably by significant amounts — since they do not capture as Canadian the considerable investments routed through intermediate countries, especially the Netherlands and tax havens such as the Netherlands Antilles, Bermuda, the Bahamas, and Panama. Statistics Canada does attempt to trace outward investments to their ultimate locations but reports that it is not always possible to do so on the basis of available information. See Chris F.J. Richards, "Canadian Direct Investment Position Abroad: Trends and Recent Developments," *Canadian Statistical Review* (Statistics Canada), June 1985, pp. vi–xx. Appendix A describes in greater detail the differences between the U.S. Department of Commerce and the Statistics Canada data in this area.

Table 7
Direct Investment Position of Canadian Real Estate in the United States, 1975–85
(U.S.$ millions)

	Canadian real estate in United States	Percentage change	Total foreign-owned real estate in United States	Percentage change
1975	$109	−3.5%	$777	−3.6%
1976	119	9.2	799	2.8
1977	98	−17.6	853	6.8
1978	143	45.9	1,161	36.1
1979	334	133.6	1,820	56.8
1980	1,158	246.7	6,120	236.3
1981	1,770	52.8	8,889	45.2
1982	1,882	6.3	11,397	28.2
1983	2,274	20.8	14,636	28.4
1984	2,844	25.1	17,761	21.4
1985	2,580	−9.3	18,557	4.5

Sources: *Survey of Current Business* (U.S. Department of Commerce), various issues; U.S. Department of Commerce, *News*, BEA 85-33, Washington, D.C., June 1985.

Given this background of multinationals from a variety of countries being attracted to the United States, it is interesting to examine a sectoral breakdown of Canadian direct investment there (see Table 6). Manufacturing is still the most important single sector of activity, but it is apparent that Canada's direct investment is becoming somewhat more focused on finance, insurance, and real estate. The Canadian share of foreign investment in U.S. real estate, for example, was about 16 percent in 1984.

This share figure has actually not changed much in the past decade — throughout the 1975–85 period, it hovered around the 15 percent mark. What has changed is the value of the investment, which has grown remarkably. As shown in the left-hand columns of Table 7, the stock exploded to U.S.$2.6 billion in 1985 from U.S.$109 million in 1975, with an eightfold increase in 1979–85. Yet this major upsurge merely reflected global trends. As the right-hand columns of Table 7 reveal, the growth of the stock of foreign direct investment in U.S. real estate peaked in 1980 for the whole world. One reason Canadians found the United States attractive for real estate direct investment during the 1979–80 period was that Canadian tax incentives favored offshore investments; even so, it is apparent that Canadian real estate investment moved with that of other countries.

Summary: All in the Family

The extent to which Canadian investment in the United States is tracking that of other leading industrialized countries is quite remarkable. It provides an indication that the pull factors of accessibility to the large and diversified U.S. market and the multinationals' tendency to cross

investment are important determinants of direct investment. One can conclude that Canadian foreign direct investment in the United States is part of a universal trend, not a sudden event or a peculiarly Canadian phenomenon.

It is worth noting, however, that through such outward investment, Canada is taking its place with other advanced industrialized countries as a major exporter of capital. This process is a reflection of the maturing of the Canadian financial and economic systems, a push factor complementary to the market pull factors determining direct investment flows to the United States.

Internalization by Canadian Multinationals

The study of foreign direct investment has recently begun to coalesce around a common explanation for the activities of multinational enterprises: the theory of internalization.[4] This theory, which explicitly recognizes that a multinational enterprise usually possesses a special firm-specific advantage, such as specialized knowledge or expertise, provides another useful explanation of subsidiary production and marketing by Canadian multinationals in the United States.

Firm-specific advantages may be acquired by research and development that leads to new product lines, such as those Northern Telecom has achieved. The knowledge advantages that result are commercialized in an efficient manner through decisions made by the firm's strategic planners about the timing of product launches in home and foreign markets. Managers' decisions are also influenced by their evaluation of risk in various locations; they weigh the firm-specific advantage protected by the multinational's internal market against the perceived risk of international

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[4]Internalization theory was first applied to the Canadian context in Alan M. Rugman, *Multinationals in Canada: Theory, Performance, and Economic Impact* (Boston: Martinus Nijhoff, 1980). The argument that internalization is a general theory of foreign direct investment forms the focal point of idem, *Inside the Multinationals: The Economics of Internal Markets* (New York: Columbia University Press, 1981).

The writer credited with the development of this industrial organization view of foreign direct investment is Stephen Hymer, *The International Operations of National Firms: A Study of Direct Foreign Investment* (Cambridge, Mass.: MIT Press, 1976, first appeared as PhD diss., MIT, 1960). However, it has been argued recently that Hymer's seminal work was somewhat one-dimensional in that he was preoccupied with analysis of entry barriers and the endogenous asset power of multinationals and did not offer a balancing consideration of transaction costs exogenous to the firm (see John H. Dunning and Alan M. Rugman, "The Contribution of Hymer's Dissertion to the Theory of Foreign Direct Investment," *American Economic Review* 75 [May 1985]: 228–232).

Dunning and Rugman also argue that this emphasis has led Hymer's followers to view the multinational as the possessor of monopoly-type rents, which need to be regulated. A broader view is that multinationals need to use internal markets in response to exogenous market imperfections, an interpretation that does not lead to any specific recommendation for regulation.

operations. Production and marketing by controlled affiliates of the enterprise, rather than through licensing or exporting arrangements, may protect the knowledge advantage from premature dissipation.

Not all firm-specific advantages, however, depend on research and development leading to new production methods. Many arise from marketing strengths. As will be demonstrated in Chapter 3, most of Canada's largest multinationals are mature, resource-based firms. They have exclusive marketing skills, networks of distributors, and long-standing relationships with customers. The management teams of such enterprises have built firm-specific marketing advantages on Canada's comparative advantage in resources — that is to say, these multinationals have internalized the country-specific advantage in resources.[5]

The mature, resource-based nature of Canadian foreign direct investment in the United States is of great importance to this study. The exporting of resource-based products from Canada is no longer a simple process. As U.S. protectionist pressures increase against softwood lumber, fish, agricultural, and other resource-related products, Canadian firms increasingly can secure market access only by joint ventures or foreign direct investments.

Even more nontariff barriers face Canadian manufactured exports. Since the rise of contingent protection in the United States in the late 1970s and early 1980s, Canadian manufacturers have found it increasingly difficult to service the U.S. market from domestic production facilities. In order to maintain their growth, such firms need to circumvent nontariff barriers by making direct investments in the United States.

A far-reaching bilateral trade agreement presumably would remove the need to jump trade barriers. Yet, even if such an agreement is negotiated, the incentives for internalization will remain, reinforced by the sunk costs of existing investment. The situation might parallel that of the European Community, where, it is argued, trade liberalization during the past two decades was accompanied by an increase in intra-industry trade and foreign direct investment.[6]

Summary

The upsurge of Canadian direct investment in the United States in recent years reflects the growing tendency of that country to close its markets to imports of resources as well as manufactured products.

Canadian multinationals in the United States are a special group, since they rely much more on their marketing advantages than do the more technologically based multinationals from Europe and Japan. This fact may

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[5]These points are developed in more detail in Chapter 3. See also Alan M. Rugman and John McIlveen, *Megafirms: Strategies for Canada's Multinationals* (Toronto: Methuen, 1985).
[6]Bernard M. Wolf, "Canadian Direct Investment in the United States: The Impact of Freer Trade" (paper presented to the North American Economics and Finance Association and the Allied Social Services Association annual meetings, New York, December 28–30, 1985).

soften the tensions between Canada and the United States, since much of the Canadian direct investment is complementary to U.S. production, rather than competitive with it.

International Diversification

A factor that may be pushing Canadian investment south of the border is the general desirability of international diversification. The concept originally focused on portfolio investment. Opportunities for international diversification occur when movements in the stock markets of various countries lack perfect positive correlation. The view that gains could be realized from holding an internationally diversified portfolio was first developed by Herbert Grubel.[7] Subsequent empirical research confirms that international diversification offers opportunities for risk reduction, a finding that has led to the development of mutual funds consisting of portfolios of international stocks.[8]

Most of these studies also demonstrate the high degree of correlation between Canadian and U.S. stock price movements. Indeed, the Canadian stock market does not usually appear in an efficient world market portfolio since it is dominated by the U.S. stock market, which has less risk at similar levels of return. This fact should encourage individual Canadians to invest in the United States rather than in Canada, in order to benefit from the superior risk-return performance of the U.S. stock market. However, individuals encounter informational and institutional impediments that restrict their actual practice of such international diversification.

An alternative method of capturing the gains of international diversification is to purchase the stock of U.S.- or Canadian-based multinationals that operate in foreign countries. Provided the business cycles of the countries involved are not perfectly, positively correlated, a multinational should be able to realize a more stable stream of earnings over time than would a purely domestic corporation confined to the vagaries of its own national market.

This argument is not universally accepted. Some writers say that multinationals are poor tools for international diversification and that individuals are better off buying directly into the stocks of other countries or into world mutual funds.[9] But these analysts ignore the point that direct purchases are sometimes too costly or practically impossible for individuals. In the face of such market imperfections, multinationals can be considered surrogate vehicles for international diversification.

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[7]Herbert G. Grubel, "Internationally Diversified Portfolios: Welfare Gains and Flows," *American Economic Review* 58 (December 1968): 1299–1314.

[8]Alan M. Rugman, *International Diversification and the Multinational Enterprise* (Lexington: D.C. Heath, 1979).

[9]See Bertrand Jacquillat and Bruno H. Solnik, "Multinationals Are Poor Tools for Diversification," *Journal of Portfolio Management* 4 (Winter 1978): 8–12.

The ability of U.S. multinationals to generate more stable profits than uninational firms has been confirmed on the basis of a test across the *Fortune* 500 firms during the 1960–69 period.[10] No specific tests have been made of the ability of Canadian-based multinationals to reduce risk by their international operations, but the assumption seems logical.

One must exercise caution, however, in assuming that Canadian firms can garner significant diversification benefits by operating in the United States. The concentration of Canadian direct investment in the United States and the high correlation of the U.S. and Canadian economies mean that Canadian firms operating south of the border have only limited opportunities for real asset diversification.

However, M. Levi has suggested to me that international diversification has another benefit for Canadian consumers. Direct investment abroad may help to make Canadian incomes less volatile by spreading components of Canada's gross national product across other countries, rather than having production and incomes dependent on the domestic market alone. In other words, foreign direct investment can be a stabilizing component of national wealth, helping to insulate Canada from some of the impact of real exchange-rate changes. One must note, however, as before, that these benefits are limited by the high correlation of the U.S. and Canadian economies.

There have been no major changes in recent years that would have prompted an upsurge of Canadian outward investment based on international diversification alone. It would be unwise to view this motive as a major one for direct investment in the United States. Rather, it is a supplement to other pull determinants.

Capital Markets and Canadian Direct Investment

Capital market imperfections have the potential to affect both the propensity of Canadian firms to operate in the United States and their activities there. A great number of Canadian and U.S. fiscal policies and capital market regulations drive tax wedges and other financial imperfections into the determination of bilateral investment flows. Although many of these institutional factors have their primary impact on portfolio capital flows, they can have secondary effects on direct investment, which make them worth considering in this study.[11]

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[10]Rugman, *International Diversification*, Chapter 3.

[11]The relative importance of Canadian portfolio investment and direct foreign investment is reported in Appendix B, Table B-3. During the 1973–80 period, portfolio investment was about one-third of all Canadian long-term investment in the United States, while direct investment constituted the remaining two-thirds. A more detailed analysis of the relative roles of direct and portfolio investment, in relation to other key items in Canada's balance of payments accounts, appears in Table B-4. The theoretical analysis of these relationships for the 1967–75 period is available in Rugman, *Multinationals in Canada*, pp. 141–145.

Tax Havens and the Double Dip

Enterprises active in two or more countries may be able to combine the various jurisdictions' tax regulations with results never envisioned by policymakers. For example, it is technically feasible for a Canadian-based multinational to use a triangular financial maneuver through a tax-haven country to claim interest deductions on debt capital raised in Canada to finance its investment in the United States. This double dip into government-decreed interest deductions is described by Donald Brean.[12]

First, the parent borrows in Canada and claims the normal tax deduction for interest on funds for corporate investment. Next, it transfers the borrowed funds, at zero interest, to a financial subsidiary located in a tax haven such as the Netherlands Antilles. This subsidiary then loans the funds to an operating subsidiary of the multinational in the United States, charging normal interest costs to this final user of the funds. The revenue of the U.S. subsidiary is repatriated as an intracorporate dividend on which no U.S. withholding tax is paid. The interest payments accrue as tax-free income to the financial subsidiary in the tax haven. The operating subsidiary is entitled to claim an interest deduction in the United States, in effect realizing for the multinational enterprise a deduction additional to the one claimed on the same funds in Canada.[13]

Table 8 is a numerical example of how this double dip works. By using an offshore financing company, the company reduces its U.S. taxable income by $10 and consequently reduces its income tax expense by $4. Since this $10 is earned in a country that does not have an income tax, the reduction in U.S. tax is not offset by an increase in the taxes due some other country. Consequently, if the dividends from the tax-haven company can be repatriated without attracting additional tax, an additional $4 is available for reinvestment or distribution to the shareholders.

This double dip serves to increase the overall after-tax income of the multinational — by $4 in the example. Income earned by the U.S. subsidiary can be repatriated to Canada in the form of intracorporate dividends, which are not subject to U.S. taxation. Finally, the interest income accrued in the tax haven can also be repatriated to Canada. The net effect for the parent company is that foreign investment in its U.S. subsidiaries can be financed by Canadian debt capital on a cost-free basis. What the double dip imposes is a social cost in terms of foregone tax revenue for the United States.

Brean reports that Canadian multinationals use both the Netherlands Antilles — which, as a tax haven for U.S. inward investment, is many times larger than other Caribbean islands or Bermuda — and the Netherlands

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[12]Donald J.S. Brean, *International Issues in Taxation: The Canadian Perspective* (Toronto: Canadian Tax Foundation, 1984).
[13]Ibid., p. 120.

Table 8
An Example of the Double Dip

	Double dip			No double dip	
	Canadian parent	Subsidiary in tax haven	U.S. subsidiary	Canadian parent	U.S. subsidiary
Operating income before interest and tax	800		100	800	100
Interest expense	(10)		(10)	(10)	
Interest revenue		10			
Income before tax	790	10	90	790	100
Income tax	(316)		(36)	(316)	(40)
Net income	474	10	54	474	60
Available for reinvestment or dividends		$538		$534	
Extra available with double dip		$4			

Assumptions: 1. The subsidiaries can pay dividends tax-free to the parent company.
2. The Canadian parent borrows $100 in Canada at 10 percent interest to finance the U.S. operation. Intrafirm loans are interest free.
3. The corporate tax rate is 40 percent.

itself for such financial maneuvers. Indeed, he suggests that these two locations are "widely used to finance the U.S. and other operations of Canadian resident multinationals."[14]

Summary

For this study, one interesting issue is whether the possibility of such interplay of tax laws — which is quite legal — acts as a push for Canadian investment abroad.[15] It seems unlikely, however, that Canadian multinationals make direct investments in the United States, rather than in Canada, simply to take advantage of such tax breaks. The primary motive for establishing an operating subsidiary is economic, not financial. Once real income is earned abroad, special financial arrangements are welcomed to increase the after-tax income accruing to the parent company. Such

[14]Ibid.

[15]It also raises the empirical issue of identifying the nature and extent of foreign direct investment moving from Canada through the Netherlands and the Netherlands Antilles. In the absence of such studies, the magnitude of this effect can only be guessed at. One can note as a guideline that on a total Canadian outflow of direct investment of $25.8 billion in 1980, Statistics Canada made an adjustment of some $5 billion in 1980 to reflect such tax-haven effects. One can also speculate that net outflows of U.S. direct investment to Canada fell partly because one provision of the 1981 U.S. *Economic Recovery Tax Act* reduced the value to multinationals of their foreign tax credits.

manipulation, however, will not turn a losing venture into a profitable one. In other words, the foreign entity is created to secure market access or to serve strategic corporate objectives that call for diversification or consolidation of assets in the United States. These underlying economic and managerial reasons for foreign direct investment are then supplemented by consideration of possible maneuvers, such as obtaining interest-free loans and tax-free income through existing legal and institutional arrangements between the United States and Canada.

Transfer Pricing

Another reason for keeping financial and tax-related manipulations of liquid assets, such as the double dip, in perspective is that the multinational enterprise has other mechanisms for the internal movement of funds.[16] The most important of these is transfer pricing: a multinational can use internal prices that differ from conceptually arm's length (market-determined) prices. In the absence of regular markets, the use of transfer prices in the internal markets of multinationals is a common and probably efficient mechanism.[17]

These internal prices, however, probably are not very important in the context of this study. There is little evidence that Canadian multinationals direct an unusual amount of their energies to purely financial transfer pricing, other than that appropriate for vertically or horizontally integrated corporations. One probable reason is that managers of Canadian multinationals are aware that the U.S. Internal Revenue Service can use section 482 of its tax code to determine any significant difference between the reported transfer prices and the tax authority's guess as to the proper arm's length price. This U.S. policing mechanism serves as a disincentive to abuse of transfer pricing.

Canadian multinationals are more likely to be concerned about being caught up in the dispute between the U.S. federal and state governments about unitary taxation. California and several other states have laws enabling them to tax an operating subsidiary of a multinational enterprise on the basis of the latter's worldwide sales rather than only on its output in the state.[18]

Since foreign multinationals consider that they are already paying U.S. corporate tax, as well as similar federal-level taxes in their home and other host countries, they feel that the use of the unitary taxation principle leads to double taxation. To a degree, the views of non-U.S. multinationals have

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[16]See Donald J.S. Brean, "Fiscal Dimensions of Transfer Pricing," in Alan M. Rugman and Lorraine Eden, eds., *Multinationals and Transfer Pricing* (London: Croom Helm, 1985), pp. 149–163.

[17]See Rugman and Eden, eds., *Multinationals and Transfer Pricing*, especially Chapters 1, 9.

[18]Alan M. Rugman and Sheila Douglas, "How to Tax Multinationals," *Policy Options* 5 (November 1984): 19–22.

prevailed on this issue. The U.S. federal government has reached a compromise with individual states that will provide them with more information on the worldwide taxes paid by multinationals resident there. In return, individual states' application of unitary taxation principles is slowing down, and some of them, such as Florida, have repealed their laws in this area.

Other Capital Market Imperfections

Once it has made its primary decision on foreign direct investment, the multinational has some degree of choice about the best means of channeling funds to the subsidiary. Tax and capital market considerations are more likely to be important determinants of these secondary decisions.

Given the existing institutional arrangements, one result may be that Canadian multinationals are encouraged to rely on debt financing, rather than on equity, for expansion of their U.S. operations. Such a push factor would help to explain the common observation of the Canadian financial community that the debt-to-equity ratio is higher for Canadian corporations than for their U.S. counterparts. The argument is that Canada's capital market is smaller and thinner than that of the United States. The larger, more diversified U.S. market encourages Canadian corporations to move their investments there, where there are more attractive risk-adjusted rates of return. An additional incentive to go to the U.S. capital market is that it is a more mature market with greater opportunities for diversification and expansion than the relatively small and underdeveloped Canadian market, in which a firm's position can soon be exhausted.

Another push factor lies in the fact that institutional investors are constrained by a provision of the Canadian *Income Tax Act* requiring that no more than 10 percent of a portfolio be in the form of foreign securities if it is to qualify for favorable tax treatment. This rule distorts the efficiency of the Canadian capital market by diverting investments from retirement savings plans and mutual funds into Canadian debt instruments rather than foreign equity. One can also argue that the rule has implications for direct investment, since it makes it relatively more attractive for institutional investors to make loans to or buy securities in Canadian multinationals, which then use the loans for their own foreign investments. In this manner, institutional investors, such as pension fund managers, are able to buy indirectly into the U.S. equity market in which the Canadian subsidiaries are most active — the type of international real-asset diversification discussed above.

The specific focus of this financial viewpoint on portfolio investment needs to be recognized; the effects on Canadian outward direct investment

are only indirect.[19] The regulations that distort the efficiency of the Canadian capital market are imposed by government policies. The United States has similar tax and other regulations that distort its investors' decisions.

Moreover, despite the two countries' tax and institutional regulations, there is a remarkably high degree of integration of the U.S. and Canadian capital markets. The extent to which Canadian multinationals can further arbitrage any residual capital market imperfections is unknown but probably very small.

Summary

It seems unlikely that Canadian multinationals make long-term economic investments in U.S. plants entirely because of tax provisions or other special financial arrangements, which could be changed by government actions at any time. For one thing, many capital market situations are subject to fundamental — indeed, abitrary — changes by government. Regulations are also subject to interpretation in which the view of the company and that of the authorities may conflict.[20] Yet direct investment, by its

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[19]There is an extensive literature on the financial variables explaining portfolio capital movements between Canada and the United States. See, for example, Paul Wonnacott, *The Floating Canadian Dollar: Exchange Flexibility and Monetary Independence* (Washington, D.C.: American Enterprise Institute, 1972); Robert M. Dunn, *The Canada-U.S. Capital Market: Intermediation, Integration, and Policy Independence*, Canada-U.S. Prospects 2 (Montreal: C.D. Howe Research Institute, 1978); J.C. Pattison, *Financial Markets and Foreign Ownership* (Toronto: Ontario Economic Council, 1978); and Daniel M. Shapiro, *Foreign and Domestic Firms in Canada: A Comparative Study of Financial Structure and Performance* (Toronto: Butterworths, 1980).

Wonnacott and Dunn place the special role of portfolio and direct investment in perspective against an analysis of the balance of payment accounts of the two countries. Financial capital flows are responsive to interest rate differentials, while direct investment is determined more by variables representing national income or changes in income. A more detailed theoretical version of this type of model appears in R.G. Penner, "Policy Reactions and the Benefit of Foreign Investment," *Canadian Journal of Economics* 3 (May 1970): 213–222.

Pattison and Shapiro examine the performance of foreign-owned firms in Canada in relation to Canadian firms. Shapiro demonstrates that U.S. subsidiaries in Canada have the lower debt-to-equity ratio since they rely on retained earnings and affiliate borrowing to "avoid incurring debt in the relatively high interest rate Canadian market" (*Foreign and Domestic Firms in Canada*, p. 48). Pattison also finds a low debt-to-equity ratio in foreign-controlled firms. This finding implies that U.S. financial norms are more relevant to the behavior of U.S. subsidiaries in Canada than are host-country factors. It is not at all clear, however, that the reverse holds — that Canadian subsidiaries in the United States follow the financial practices of their Canadian parents, who use more debt than equity. The U.S. and Canadian economic and financial systems are asymmetric, with the U.S. market ten times as large as the Canadian. The financial practices of Seagram and other large Canadian-owned multinationals operating in the United States are much more likely to be determined by U.S. capital market norms, rather than Canadian ones, since the greatest part of their sales come from their U.S. subsidiaries. Only for the more diversified or smaller Canadian multinationals are Canadian home market financial factors likely to negate the overwhelming influence of the United States.

[20]For example, Revenue Canada tried to disallow for tax purposes the extra markup paid to offshore subsidiaries of multinational oil companies, thus invalidating a popular transfer pricing scheme. However, the Federal Court of Appeal reversed the decision and revived the offshore arrangement. See "Current Cases: Spur Oil Ltd. v The Queen," *Canadian Tax Journal* 29 (November–December 1981): 838–841.

very nature, commits the parent multinational to an expensive, discrete long-term investment in its foreign subsidiary. The parent has to make strategic decisions about the management operations, marketing, and human resource functions of the subsidiary as well as about its financing. Firms are unlikely to make major commitments in these other areas simply to facilitate financial manipulations.

Political Risk in Canada

A factor that might be significant in pushing outflows of capital from Canada is a change in investors' perception of the country's political risk, especially relative to that of the United States. In times of political upheaval, foreign investors may turn away from Canada, and Canadian investors may prefer to move funds to the perceived stability of the U.S. capital market. The ongoing movement of financial (portfolio) capital between the United States and Canada is certainly sensitive to political events insofar as they affect risk-adjusted rates of return. There is also the possibility that direct investment decisions may be affected by changes in the political environment.

For example, one can argue that in late 1976, when the separatist Parti Québécois was elected in Quebec, U.S. direct investment into Canada was deterred. It is suggested that the risk premium increased at that time, so that Hydro-Québec and other Canadian borrowers found it more difficult and expensive to raise U.S. capital. A parallel situation arose in 1980–81 when the National Energy Program made it unattractive for U.S. firms to retain their positions in Canadian energy development. Both occasions produced incentives for Canadian direct investors to divert funds from domestic expansion to investment in new plant or acquisitions abroad, especially in the United States. The poor climate for investment in Canada at such times inevitably increases the relative attractiveness of the United States.

It is apparent, however, that such periods of heightened political risk are relatively short-lived; indeed, the climate was reversed by 1985. One must say, therefore, that long-term direct investment decisions are likely to be influenced more by pull factors than by such a transitory push factor.

A related argument is that Canadian regulations that deter U.S. investment in Canada can also weaken the Canadian capital market. In 1980 and 1981, for example, the Foreign Investment Review Agency (FIRA) was particularly stringent in assessing the significant benefit to Canada of prospective foreign ownership, and the screening mechanism became a considerable barrier to U.S. investment in Canada.[21] Deterring foreign investment from entering the Canadian capital market may have contributed

[21] Alan M. Rugman, "Canada: FIRA Updated," *Journal of World Trade Law* 17 (July–August 1983): 352–354.

to a general lack of liquidity in overall Canadian investment, which raised the risk premium both for U.S. multinationals in Canada and for Canadian multinationals in the United States. The relatively thin Canadian capital market thereby drove capital offshore to the U.S. market, which presumably offered more attractive expected returns. A similar argument can be advanced about the introduction of FIRA in 1974, when investors' perception of political risk may have been heightened by the agency's enthusiastic initial screening, a process that subsequently became routine and no significant barrier to inward investment for a few years.[22]

Overall, the significance of perceived political instability as a financial push factor should not be exaggerated. Like the capital market imperfections already analyzed, it is probably a secondary factor in decisions about long-term direct investment and much less important than the pull factors that appear to be the key determinants. Again, firm managers must satisfy themselves that a project is economically viable before any financial push factor can affect the investment decision.

Conclusion: Canada in a Global Economy

Firms can either be pushed or pulled into making foreign direct investment. Canadian investment in the United States reflects a mixture of both forces, but the pull is much stronger than the push. Moreover, economic factors are important in leading firms to invest abroad, but managerial (firm-level) decisions are what count. Such managerial determinants of direct investment are difficult to untangle from broader economic factors. Today's global economy is becoming more interdependent, and Canada's outward direct investments are part of this process of international competition.

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[22]Rugman, *Multinationals in Canada*, Chapter 10.

3

Managerial Determinants of Canadian Outward Direct Investment

The trends of foreign direct investment discussed previously result from the decisions of individual companies and managers. Therefore, this chapter focuses on the strategies chosen by the decisionmakers of Canada's multinational enterprises.

Of the 800 or more Canadian-owned companies with subsidiaries abroad, the U.S. Department of Commerce has identified some 700 as having foreign affiliates in the United States in 1980. A mere handful of them are responsible for the great bulk of Canada's investments in the United States. The first part of this chapter discusses the nature and special strength of these large Canadian-owned multinationals. This is followed by a review of several studies on the motives for Canadian outward investment. Finally, the transactions of Canadian multinationals in the United States during the 1978–83 period are related to global trends in direct investment.

The Canadian Multinationals

There are more than 10,000 multinational enterprises in the world today, but the largest 500 undertake more than 80 percent of all foreign direct investment. About half these giants are based in the United States, another 60 in Japan, and most of the remainder in Europe.[1]

Canada has about a score of multinationals in these big leagues. Those with sales of more than $2 billion a year include Alcan, Seagram, Noranda, Hiram Walker, NOVA, Northern Telecom, Massey-Ferguson, MacMillan Bloedel, Moore, and, in good years, Inco. To these ten firms can be added the next eight largest multinational enterprises: Genstar, Domtar, Abitibi-Price, Molson, John Labatt, Consolidated-Bathurst, AMCA, and Cominco.[2] For interest and completeness, an analysis should also include representatives of some of the many smaller Canadian multinational enterprises with sales of less than $500 million; this study uses Bombardier

[1] John M. Stopford and John H. Dunning, *Multinationals: Company Performance and Global Trends* (London: Macmillan, 1983).

[2] Notice that these lists focus on operating firms, ignoring conglomerate ownership. Including holding companies would, of course, have changed the names in the lists; for example, they would have included Canadian Pacific, with 1984 sales of more than $13 billion and control over AMCA and Cominco. However, a conglomerate with wide corporate diversification, such as CP, does not lend itself to meaningful analysis of the determinants of foreign direct investment at the company level. Moreover, the ongoing wave of conglomerate reorganization — CP's divestiture of Cominco is just one example — would have outdated the lists before this study could be printed.

Table 9
Large Canadian Industrial Multinationals

	Sales[a] (Can.$ millions)	Foreign to total sales (%)	Foreign countries in which active	R&D as percentage of sales	Return on equity[b] (%)
	(1)	(2)	(3)	(4)	(5)
Alcan	$5,879	84%	28	1.1%	10.3%
Seagram	3,169	92	20	n.a.	10.2
Noranda	2,867	53	17	0.3	13.2
Hiram Walker	2,867	42	5	n.a.	11.6
NOVA	2,665	29	4	n.a.	12.5
Northern Telecom	2,573	79	11	9.8	13.8
Massey-Ferguson	2,542	91	33	2.3	4.9
MacMillan-Bloedel	2,143	79	7	0.4	8.5
Moore	2,141	90	39	0.8	17.3
Inco	1,929	85	14	2.5	9.5
Genstar	1,861	60	1	0.1[c]	14.1[d]
Domtar	1,684	29	2	0.3	11.4
Abitibi-Price	1,577	63	1	0.3	10.5
AMCA	1,515	76	7	1.1	12.0
Molson	1,434	32	35	n.a.	15.8
John Labatt	1,432	n.a.	3	0.3	15.0
Consolidated-Bathurst	1,386	54	3	0.2	12.6
Cominco	1,349	73	12	0.4	13.4
Bombardier	419	67	4	n.a.	5.2[e]
National Sea Products	339	71	5	0.2	11.6[f]
Mean[g]	2,279	66	13	1.4	12.0
Median	1,875	71	7	0.4	11.8

[a]Average 1979–83.
[b]1970–83.
[c]1982.
[d]1970–82.
[e]1978–82.
[f]1977–82.
[g]Excludes Bombardier and National Sea Products.

Source: Adapted from Alan M. Rugman and John McIlveen, *Megafirms: Strategies for Canada's Multinationals* (Toronto: Methuen, 1985), Tables 2.1 and 2.2.

and National Sea Products. The result gives the multinationals listed in Table 9.[3]

The 18 largest Canadian-based multinationals have, on average, 66 percent of their sales abroad (see column 2 of the table).[4] This figure

[3]This list is also the sample used for analysis in Alan M. Rugman and John McIlveen, *Megafirms: Strategies for Canada's Multinationals* (Toronto: Methuen, 1985).
[4]Notice that foreign sales are here defined to include both sales of foreign subsidiaries and exports by the parent firm. Seven of these 20 firms do not report separately subsidiary sales from exports. Of those that do, the average sales by subsidiaries is 38 percent of total sales.

represents an astounding degree of foreign involvement. To put it in perspective, it is worth noting that the 50 largest U.S.-owned multinationals have an average foreign-to-total-sales ratio of 36 percent; the 20 largest Japanese, 43 percent; and the 50 largest European, 60 percent.[5]

Further evidence of the multinationality of these Canadian enterprises is that they are active in an average of 13 foreign countries. The major foreign market for all of them is, of course, the United States. Yet, firms such as Moore, Massey-Ferguson, and Alcan also invest in more than 20 other countries; of the enterprises listed, only Genstar and Abitibi-Price restrict their foreign activity to the United States.

Research and Financial Performance of Canadian Multinationals

Table 9 suggests two other characteristics of this group of Canadian multinationals. First, column 4 reports their ratios of research and development to sales. The average is 1.4 percent; excluding Northern Telecom — an enterprise of the traditional R&D-intensive type — reduces this to only 0.8 percent. The median is only 0.4 percent.

In contrast, the largest U.S., European, and Japanese multinationals have an R&D-to-sales ratio of about 3 percent. Yet, the relative lack of R&D by Canadian multinationals does not appear to be any handicap to their financial performance, reported in column 5. Their return on equity (ROE) averages 12 percent, a figure not significantly different from the profit rate of the world's other large multinationals. U.S. and Japanese multinationals also average about 12 percent ROE, while the 50 largest European multinationals, which include 17 unprofitable state-owned enterprises, earn only about 8 percent.[6]

The Special Advantages of Canadian Multinationals

The low level of R&D but nevertheless satisfactory earnings of Canada's multinational enterprises provides a clue that the reasons for their success lie in areas different from those of their global rivals. In interviews with the strategic planners of the 20 Canadian multinationals listed, Rugman and McIlveen found that their advantages tend to be in marketing and distribution, rather than in innovation and new product development.[7] Most Canadian multinational giants are operating in mature or resource-based product lines, yet their excellent managerial skills and marketing advantages make them able to perform as well as other multinational enterprises.

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[5]Alan M. Rugman, "The Comparative Performance of U.S. and European Multinational Enterprises," *Management International Review* 23 (1983): 1–14. Other comparative data in this section are from the same source.
[6]Ibid.
[7]Rugman and McIlveen, *Megafirms*.

In other words, the Canadian firms are not just "hewers of wood and drawers of water." Rather, they tend to operate a value-added chain with three elements. First, they have, over time, secured proprietary access to Canada's abundant resources, using their initial ability to evaluate and develop resource properties. For example, pulp and paper firms have signed long-term timber leases with provincial governments and have participated in the construction of roads and other infrastructure. Mineral resource firms have invested in exploration and development and thereby established rights to mineral deposits. Metal-producing firms have secured access to cheap energy, water generated or otherwise, for long periods.

Second, Canadian multinationals are now engaged in the processing and fabrication of product lines based on natural resources. Pulp and paper firms own domestic newsprint mills and have acquired others abroad. Alcan is expanding its aluminum fabrication facilities and developing new product lines. Mining and construction firms have integrated forward to produce products for foreign customers. Thus, foreign direct investment increasingly has been seen as a supplement to traditional exporting for Canada.

Third, all these Canadian multinationals have developed distribution networks and marketing expertise. The pulp and paper firms have long-standing close relationships with foreign newspaper publishers; Moore produces highly customized office forms and support systems; the liquor and beverage enterprises use their own distributors or agents with whom they are very familiar; the mining and construction firms try to work closely with their customers to put together packages of services in which the financial power of the multinational is an important asset in such capital-intensive ventures.

This value-added chain of resource-based extraction, processing, and marketing gives the typical Canadian multinational strong competitive strengths. It is able to set its managerial expertise in the proprietary use of Canada's resources against the R&D-induced advantages of rival multinationals. Thus, Canadian firms are frequently in complementary, rather than directly competitive, positions with most other multinationals — an excellent strategic position. Yet, it is essential that Canadian-based enterprises retain access to foreign markets.

Motives for Canadian Foreign Direct Investment

Neil Matheson has conducted a survey of the senior managers at some 18 Canadian companies, including a bank and several smaller firms.[8] His

[8]Neil Matheson, "Canadian Investment Abroad" (Paper presented to the Annual Conference of the International Business Council of Canada, Montreal, April 1985, Mimeographed). Of the companies included in Matheson's research, only eight were on the list of Canada's largest multinationals identified by Rugman and McIlveen in *Megafirms*. One reason was Matheson's inclusion of eight smaller companies with sales of less than $1 million in 1984.

survey provides some useful pointers as to the reasons Canadian firms invest abroad and the importance of such investment in the Canadian economy.

Matheson reports five major motives for foreign direct investment during the 1980–84 period:

- to overcome trade barriers;
- to serve foreign markets;
- to gain access to raw materials;
- to strengthen an existing business; and
- to diversify into other businesses.

These reasons are not mutually exclusive, and several of the firms mentioned more than one.

Matheson concludes that the first two motives were the principal factors in half of the case studies reported and cites the third as significant for energy firms. The last two factors have grown in importance since the 1970s — Matheson says they were important in about half the recent cases he examined. He suggests that this finding is evidence that Canadian companies are engaged in the restructuring of their businesses internationally as well as domestically. To put the point another way, Canadian multinationals are undertaking strategic planning both to expand successful businesses and to diversify into new areas. Indeed, most Canadian outward investment is now reported to be in the form of acquisitions rather than new operations.

Matheson's last two motives — growth for strength and diversification — are similar to those found by Stopford and Turner in a study of the acquisitions made by mature U.K. multinationals in the United States in the early 1980s.[9] The unique problem of Canadian multinationals is their need to defend themselves against trade barriers in the nearby U.S. market, without which most of them would be dead. Matheson's first two motives really collapse into Canadian firms' need to retain access to foreign markets.

The need to overcome tariff or nontariff barriers to trade is a classic motive for switching from exporting to foreign direct investment. Seven successive rounds of negotiations under the General Agreement on Tariffs and Trade have reduced most bilateral tariffs to small amounts (although the effective rates of protection escalate by the degree of value added, so Canadian exports of some processed resource products are still impeded by the United States). Clearly, it is nontariff barriers that have recently

[9]John M. Stopford and Louis Turner, *Britain and the Multinationals* (London: John Wiley, 1985).

been most important in accelerating Canadian foreign direct investment. In the United States, these nontariff barriers include federal and state local procurement policies and regulations affecting the standards and quality of imported products. They also include a wide range of contingent protection measures, such as antidumping and countervailing duty actions, involving allegations of injury to U.S. producers from alleged Canadian dumping or subsidies, that are brought before the U.S. International Trade Commission and the U.S. Department of Commerce. A Canadian firm can avoid many of these barriers by producing in the United States through a subsidiary rather than exporting from Canada.

Matheson's other motives for direct investment abroad, which can be summarized as the desire to restructure, diversify, and strengthen a company's business by foreign acquisitions, are matched and supported by the ability of Canadian multinationals to finance foreign acquisitions. One reason is the maturing of the Canadian economy. Increasing amounts of capital are available for Canadian managers to call on as they make expansions and acquisitions abroad. Of importance also is the greater ability of Canadian managers to raise funds in the United States itself to finance acquisitions and expansions there. It has been argued that domestic capital market distortions reinforce the availability of Canadian capital for foreign investment, and to some extent, the attractiveness of acquisitions may reflect a lack of Canadian investment opportunities. I suggest, however, that Canadian outflows of foreign direct investment tend to be complementary to domestic investment, rather than a substitute for it.

Motives for Smaller Multinationals

In a now classic study of smaller Canadian multinationals, Litvak and Maule also find market factors to be of overwhelming importance as a motive for Canadian foreign direct investment.[10] In 1978, they surveyed, mostly by interview, a sample of 25 small and medium-sized technology-based firms from the Canadian secondary manufacturing sector. Table 10 reports the reasons given by these 25 firms for investing in the United States.

It is apparent from an examination of the table that virtually all smaller multinationals ranked access to the U.S. market as the major reason for investing there. Cost factors were of minor importance in comparison to market considerations. Similarly, the push factors of Canadian political and social problems, such as the debate about Quebec's future in Confederation at the time of the survey, were less important than firm-specific factors, such as technological knowledge. Other Canadian environmental

[10]Isaiah A. Litvak and Christopher J. Maule, *The Canadian Multinationals* (Toronto: Butterworths, 1981).

Table 10
Reasons for Investing in the United States: A Survey of 25 Small Canadian Companies

	Number of firms finding reason			
	Very important	Important	Of minor importance	Unimportant
Market considerations				
Maintain or increase market share in U.S.	22	0	0	3
Faster sales growth in U.S. than in Canada	21	2	1	1
Difficult to reach U.S. market because of tariffs, transportation costs, or nationalistic purchasing policies	16	4	3	2
Diversify product line/geographic market	18	2	1	4
Increase responsiveness to U.S. customer demands and improve servicing capability	12	10	2	1
Integrate forward/backward	1	1	0	23
Promote exports from parent Canadian firm through U.S. subsidiary	2	2	0	21
Secure U.S. sources of materials supply	2	2	3	18
Export from U.S. to third countries	4	1	2	18
U.S. production/cost factors				
Availability of advanced technology	3	1	1	20
Availability of natural resources	1	0	2	22
Availability of fuel	1	0	1	23
Availability of stable labor force	9	6	2	8
Availability of managerial talent	4	4	5	12
U.S. politico-economic environment				
General political stability	3	5	5	12
Trade unions' attitudes	5	3	4	13
More favorable taxation policies	5	3	5	12
Relative freedom from regulatory constraints	5	3	2	15
Easier access to financing	5	2	5	13
Wage/price policies	7	2	5	11
Federal government economic incentives	0	2	1	22
State government economic incentives	2	1	1	21
"Buy America" policies	7	3	1	14
Firm's Canadian corporate resources and capabilities				
Possession of superior technology	21	4	0	0
Growth in experience in international business	17	6	2	0
Growth in corporate capacity to finance investment via retained earnings/ borrowing/issue of new equity	4	9	9	3
Canadian politico-economic environment				
General political climate	3	6	4	12
Quebec-Canada constitutional debate	3	4	3	15
Trade unions' attitudes	4	3	5	13
Taxation policies	4	3	7	11
Regulatory constraints	4	2	4	15
Access to financing	5	3	5	12
Anti-Inflation Board controls	3	2	5	15
Federal government policies	5	3	3	14
Provincial government policies	3	2	1	19

Source: Isaiah Litvak and Christopher J. Maule, *The Canadian Multinationals* (Toronto: Butterworths, 1981), pp. 42–43, Table 3.

factors — tax policies, trade union attitudes, and government policies — also ranked as relatively minor. The conclusion to be drawn is that the pull of market-driven considerations is much more significant than push factors as determinants of Canadian foreign direct investment.

Elsewhere in their book on Canadian multinationals, Litvak and Maule find that the larger Canadian firms are also investing in the United States for market considerations. The large Canadian-based multinationals (mostly those listed in Table 9) need to gain access to the faster-growing U.S. market and to avoid trade barriers by investing in, rather than exporting to, the United States.

Litvak and Maule also say that many of the large Canadian-owned firms have "gone international but not yet achieved a multinational status."[11] Their point is that the sales and assets of the Canadian firms they studied were largely concentrated in the United States rather than in global business. Almost a decade after the survey, this focus on the U.S. market remains true, yet it would be misleading to continue to view the Canadian companies listed in Table 9 as newcomers to the game of global competition. The data in Chapter 1 reveal that firms from all countries are now attracted to the United States. Today, Canadian companies face this global challenge in their continental markets. They must be concerned about their ability to continue to operate efficiently in it, given the rivalry of other multinationals seeking a share of the U.S. economic pie.

Other Studies of Motives for Foreign Direct Investment

Four other recent studies have examined the determinants of direct Canadian investment in the United States. Three of them used survey techniques; one has a regional focus.

Group of Thirty Study

In a survey of U.S. and European multinational enterprises by the Group of Thirty,[12] the reasons given for foreign direct investment were:

- to gain access to domestic or regional markets;
- to integrate foreign operations with existing investments — or to adapt to structural changes in the industry;
- to avoid trade barriers; and
- to seek out faster-growing markets abroad.

The list shows the rankings of these motives in decreasing order of importance, the second having shown the greatest increase since the 1970s. There

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[11]Ibid.
[12]Group of Thirty, *Foreign Direct Investment 1973-1987* (New York, 1984).

was also a trend toward acquisitions rather than new foreign direct investment.

In general, these results are similar to Matheson's; they confirm that all multinationals are concerned with market access and the need to restructure their businesses.

Department of Commerce Study

A U.S. Department of Commerce study[13] attributes the great expansion of foreign direct investment transactions in the United States during the 1976–83 period to a generally favorable climate for such investment, including:

- relative U.S. political and economic stability;
- the sheer size and strength of the U.S. economy;
- the emergence of large companies based outside the United States that have the resources needed to become active multinational corporations;
- a relatively nonrestrictive U.S. policy toward foreign direct investment; and
- the low value of the U.S. dollar during the 1978–80 period.

Gandhi's Regional Study

The critical importance of access to the relatively faster-growing U.S. market has also been cited as the major attraction for Canadian direct investment in particular regions of the United States. In a study of New York state, Prem Gandhi identifies locational familiarity and market accessibility as key factors determining Canadian direct investment in the area.[14] Factors that respondents to his survey considered "extremely important" include: nearness to parent company (81 percent); potential for growth in the United States (79 percent); location of the area (77 percent); and transportation, especially highways (64 percent). Gandhi interprets these findings as evidence that Canadian companies decide to invest in New York because that state is a gateway to the U.S. market where the subsidiary can be close to the parent. (Almost 90 percent of the respondents have parents located in Ontario or Quebec.)

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[13]United States, Department of Commerce, International Trade Administration, Office of Trade and Investment Analysis, *Foreign Direct Investment in the United States, Completed Transactions, 1974-1983*, vol. 1, *Source Country* (Washington, D.C., June 1985).

[14]Prem Gandhi, "Foreign Direct Investment and Regional Development: The Case of Canadian Investment in New York State" (State University of New York, Center for Business and Economics, Plattsburgh, 1984, Mimeographed).

Most of the 73 Canadian firms in Gandhi's study are small; 64 percent have assets of less than $1.5 million and average fewer than 100 employees; only 15 percent have assets in excess of $9 million.

The small size of the typical Canadian subsidiary in New York may explain some of the problems Gandhi's respondents report encountering. Many of the companies have been frustrated by U.S. immigration and customs laws, and many feel that federal and state taxes are too high and too complex.

Few cited state or municipal incentive schemes or regulations as important aspects in their decision to locate in New York; the size and attractiveness of the U.S. market itself was their primary concern.

In subsequent correspondence, Gandhi has stated that during the course of his interviews, the respondents made clear to him the key factor in the recent change in foreign direct investment in the United States: the competitive deterioration of the U.S. economy in the global marketplace. In the 1980s, the need for economic growth in the United States has led individual states and firms to an intensified search for investment funds, both domestic and foreign. This change in attitudes toward investment has turned the United States into a much more receptive host country, especially at the state and regional level.

The Forget and Denis Study

In a study prepared for Canada's Department of Regional Industrial Expansion, Claude Forget and Daniel Denis of the C.D. Howe Institute analyze the reasons for establishing branch plant operations in the United States.[15] In this comprehensive survey, they sent a mail questionnaire to 700 firms identified by Statistics Canada as Canadian-owned multinationals, asking about the primary factors affecting their foreign investment decision. More than 10 percent of these firms denied that they had any branch or affiliate in the United States, and another 15 percent could not be located. There were 83 respondents to the questionnaire — about 11 percent of the total — representing 22 percent of the book value of Canadian foreign direct investment in the United States in 1983. Their responses are shown in Table 11.

It is clear from the table that U.S. pull factors, such as market size, potential, and accessibility, are much more important motives than are Canadian push factors. Other noteworthy points are that investment incentives (shown under "other" pull factors) were not rated at all as important to the investment decision; that U.S. labor and other factor costs are not a major element in that decision; that trade barriers are of growing impor-

[15]Claude E. Forget and Daniel Denis, "Canadian Foreign Direct Investment in the United States: Reasons and Consequences" (Paper prepared for the Department of Regional Industrial Expansion, C.D. Howe Institute, Montreal, June 1985, Mimeographed).

Table 11
The Single Most Important Factor Influencing the Location Decision: A Survey of Canadian Firms, 1985

	Percentage of firms choosing
Pull factors	
Market size	27
Market potential	27
Proximity to customers	14
Trade barriers	5
Profit potential	4
Other	8
Total	*85*
Push factors	
Taxation	7
Unit labor costs	4
Regulation	4
Total	*15*

Source: Claude E. Forget and Daniel Denis, "Canadian Foreign Direct Investment in the United States: Reasons and Consequences" (Paper prepared for the Department of Regional Industrial Expansion, C.D. Howe Institute, Montreal, June 1985, Mimeographed).

tance; and that the overwhelming motive for Canadian investment is the attractiveness of the U.S. market.

Within these broad findings were some special cases. For example, the expansion of the Canadian petroleum and financial industries in the United States was influenced by Canada's tax policies, a push factor. To a degree, investment by smaller Canadian firms has gone to the United States because of trade union attitudes, labor regulation, and unit labor costs, all being perceived as more favorable in the United States than in Canada.

This recent survey confirms the earlier work of other analysts summarized above. All the studies find that U.S. market factors are the key reasons for Canadian foreign direct investment in the United States. Access to the large and expanding U.S. market, especially in the face of current U.S. nontariff barriers to trade, is always identified as the major reason for investing in the United States. In this sense, the investment motives of Canadian multinationals appear to be consistent with those of multinationals from other countries, all of whom seem to be attracted by the magnetic force of the United States, the current engine for world growth and development.

Analysis of Transactions

One can gain a deeper perspective on the type of Canadian direct investment in the United States by examining data published by the U.S. Department of Commerce from a monitoring program established to iden-

Table 12
U.S. Inward Investment Transactions by Source Country, 1976–83

	1976	1977	1978	1979	1980	1981	1982	1983	Total	Percent
Canada	19	92	122	180	253	291	161	97	1,215	19.0%
France	9	34	43	51	52	64	52	48	353	5.5
Japan	28	55	58	96	101	129	143	105	715	11.2
Netherlands	9	21	32	64	63	58	46	47	340	5.3
Switzerland	11	16	42	50	48	36	21	28	252	3.9
United Kingdom	36	51	107	147	185	182	180	159	1,047	16.4
West Germany	26	53	104	166	171	91	66	72	749	11.7
Subtotal	*138*	*322*	*508*	*754*	*873*	*851*	*669*	*556*	*4,671*	*73.0*
Netherlands Antilles	1	3	16	53	79	110	59	46	367	5.7
Other countries	59	103	153	228	247	242	185	149	1,366	21.3
Total	*198*	*428*	*677*	*1,035*	*1,199*	*1,203*	*913*	*751*	*6,404*	*100.0*

Source: United States, Department of Commerce, International Trade Administration, Office of Trade and Investment Analysis, *Foreign Direct Investment in the United States, Completed Transactions, 1974-1983*, vol. 1 *Source Country* (Washington, D.C., June 1985), Table 3.

tify publicly reported foreign direct investments in the United States.[16] Each investment is listed by the name and country of the foreign investor, the industry group and state of the U.S. affiliate, the value of the transaction, and the type of investment.

Table 12 summarizes the national breakdown of the 6,404 foreign investments in the United States during the 1976–83 period. Canada was the source of 1,215 of them — 19 percent of the total — the largest number from any single country. Notice that the Canadian number peaked in 1980 and 1981, which were the years when many other countries also made the most investment transactions. In the two years after 1981, transactions fell by a third because of the appreciation of the U.S. dollar, which increased the cost of acquisition of U.S. assets, and the U.S. economic recession.[17] Also noticeable is the high number of investments from Japan and the United Kingdom in 1982–83. Surprisingly small is the number from the Netherlands — only 5.3 percent of the total. Given the data in Table 5 indicating that the Netherlands has one of the world's largest stocks of direct investment in the United States, it is clear that the average value of its

[16]United States, Department of Commerce, *Foreign Direct Investment in the United States.*
[17]The tabulation of data for 1984 is not completed, but it is known that foreign acquisitions of U.S. companies in that year were at their highest level since 1981 (when many U.S. energy assets were bought). Major takeovers in 1984 were the Royal Dutch/Shell tender of U.S.$5.5 billion for the remaining 30.5 percent of its U.S. Shell Oil subsidiary, the U.S.$2.9 billion purchase of Carnation by Nestlé of Switzerland, and the stake bought in National Steel by Japan's Nippon Kokan (NKK). There was relatively little activity in the heavy industry sector but a large number of takeovers in the retail and distribution sectors, which benefited from the U.S. recovery of 1984.

Table 13
U.S. Inward Investment Transactions by Type, 1978–83

	1978	1979	1980	1981	1982	1983	Total	Percent
Acquisitions/mergers	225	344	344	291	231	192	1,627	28.2%
Equity increases	36	39	47	39	42	39	242	4.2
Joint ventures	26	35	41	47	50	38	237	4.1
New plants/plant expansions	85	153	199	129	99	125	790	13.7
Real estate purchases	149	269	350	510	298	161	1,737	30.1
Other/unidentified[a]	156	195	218	187	193	196	1,145	19.8
Total	*677*	*1,035*	*1,199*	*1,203*	*913*	*751*	*5,788*	*100.0*

[a]Includes direct investment in branches, agencies, representative offices, stores, outlets, and warehouses, as well as unidentified transactions.

Source: United States, Department of Commerce, International Trade Administration, Office of Trade and Investment Analysis, *Foreign Direct Investment in the United States, Completed Transactions, 1974-1983*, vol. 1 *Source Country* (Washington, D.C., June 1985), Table 5.

transactions must be high and concentrated on a few major investments by large multinationals, such as Royal Dutch/Shell, Unilever, and Philips.

Seven nations — Canada, the United Kingdom, West Germany, France, the Netherlands, Switzerland, and Japan — consistently accounted for almost three-quarters of all transactions. Another 5.7 percent came from the Netherlands Antilles, a source of real estate investments in particular.[18] The other country with large real estate investments in the United States is Canada, but this activity seems to have peaked during the 1976–81 period.

A suggestion of the importance of real estate purchases in those years comes from Table 13, which provides information on the type of direct investments in the United States during the 1978–83 period — a slightly shorter period than reported in Table 12. Some 30 percent of the 5,788 transactions recorded were in real estate, and 28 percent were in the form of mergers and acquisitions. In contrast, about 18 percent were new or expanded plants and equity increases, and only 4 percent involved joint ventures.[19]

If real estate purchases were excluded from the data in Table 13, the shares of each of the remaining categories would increase by about 43 percent of their original value, with acquisitions and mergers account-

[18]Many of these investments are actually made by U.S. citizens taking advantage of the tax-haven status of the Netherlands Antilles to reinvest in the United States. The U.S. tax authorities normally require companies to withhold taxes on interest payments to foreigners. By using the Netherlands Antilles as a base for investing in the United States, corporations can avoid this problenm when they borrow in the Eurocurrency market.

[19]It should be stressed that these data are on the number of transactions with no adjustment for value, so their picture is merely suggestive of the lower profile of new equity investment relative to real estate purchases and acquisitions. Notice, too, that the catchall category "other/unidentified", which includes direct investment in a variety of marketing channels as well as unidentified transactions, represents a sizable proportion — almost 20 percent — of total direct investment during the 1978–83 period.

ing for 40.3 percent of the transactions, equity increases 6.0 percent, joint ventures 5.9 percent, new plants and plant expansion 19.5 percent, and "other/unidentified" 28.3 percent. The importance of the Canadian real estate industry in the United States becomes apparent when this adjustment is undertaken.

Of the 50 largest foreign direct investments reported in the United States during the 1974–83 period, 20 were by investors from Canada and 16 were from the United Kingdom.[20] The largest single Canadian transaction in the United States was the Seagram investment in Du Pont, valued at more than U.S.$2.5 billion. Given the U.S. Department of Commerce benchmark of 10 percent ownership yielding effective control, Du Pont is now a foreign-owned — that is, Canadian-owned — company. Other major U.S. corporations that are foreign owned are Shell (the Netherlands), Texasgulf (France), and Santa Fe (Kuwait).

Summary

The evidence in this chapter provides a fascinating insight into the penetration of the U.S. corporate sector by other countries' multinationals, of which Canada's enterprises have carried out their share. Uncle Sam is now the host to multinationals from many countries and this trend is likely to continue. Of particular interest to this study is the upsurge in the investments of Canadian enterprises in the United States. Survey after survey shows that the managers of these firms, large or small, decided on direct investment south of the border primarily because of the pull of U.S. markets. Increasingly, the need to jump nontariff trade barriers seems to play a part in the choice between direct investment and export. Once the larger Canadian enterprises are operating in the United States, they generally find that the firm-specific advantages they have developed in marketing and distribution — many of them based on adding a chain of value to the resource products in which Canada has a natural comparative advantage — put them in a competitive position to firms based in the United States and other countries.

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[20]United States, Department of Commerce, *Foreign Direct Investment in the United States*; United States, Department of Commerce, International Trade Administration, *International Direct Investment: Global Trends and the U.S. Role* (Washington, D.C., August 1984).

4

Policy Implications

The reversal in Canadian-U.S. direct investment flows during the past decade and the resulting shift in relative national investment positions could have important consequences for bilateral economic relations. Net inflows of U.S. foreign direct investment into Canada historically have led to a high degree of foreign ownership of the Canadian economy. The dominance of U.S. investment in the Canadian economy resulted in a well-known set of political, social, and cultural sensitivities within Canada that created tensions in economic relations with the United States. A new pattern of interaction between the two countries may arise because of the sudden increase in the amount of Canadian investment in the United States, so it is important to begin serious analysis of the implications of the reversal.

The recent nature of the change means, however, that policy questions can be addressed only in a preliminary manner in this study. After all, several decades of analysis of foreign ownership of the Canadian economy have yet to produce a clear consensus about its effects on Canada. Clearly, however, even a preliminary assessment of the implications for bilateral economic relations of the shift in relative investment positions requires consideration of how policymakers in each country evaluate the costs and benefits of direct investments. The current investment policies of each country are an indication of perceptions of these costs and benefits, so the policies can be expected to change in future in response to the shifts in investment positions.

One must also expect that new policy developments will influence future investment patterns. Because of the linkages between investment and trade flows, a bilateral trade agreement could change direct investment flows by affecting the foreign investment decisions of the managers of multinationals in both countries. Cross investment within industries of the two countries might expand with growing trade.

This chapter examines perceptions of the costs and benefits of direct investment, discusses the possible evolution of investment policy in each country, and draws out implications for bilateral economic relations. It then turns to a consideration of the linkages between trade and direct investment and looks at the implications of freer trade.

Costs and Benefits of Direct Investment

It is neither possible nor appropriate in this short study to undertake a comprehensive analysis of the costs and benefits of Canadian outward direct investment. One can, however, list some of the issues involved for both Canada and the United States, including effects on tax receipts, the diffusion of technology and expertise, jobs, and wealth.

The application of simple economic theory suggests that as a net capital exporter of foreign direct investment, Canada might suffer a social loss of tax receipts.[1] The affiliates of Canadian multinationals operating in the United States pay U.S. state and federal corporate taxes; Canada cannot tax affiliate profits again without subjecting the multinational to double taxation. Because Canada's multinationals are a relatively new breed, the Canadian tax authorities have not yet acquired as much experience in administrating tax credits as the U.S. tax authorities apply when dealing with U.S. multinationals. Now that outward investment is a fact of life, Canada must reevaluate the effects of its tax system on that investment, especially in comparison to the treatment the United States gives its foreign investment.

Another normative consequence of outward investment is the social externality of the spread of technology and expertise. Although most of the Canadian firms investing in the United States are not highly knowledge- or technology-intensive, there is still some diffusion of the know-how they possess. The gain likely to be of greatest advantage to the U.S. economy is the diffusion of marketing skills, which are the forté of most of the Canadian multinationals.

Steven Globerman draws two other normative implications.[2] First, he suggests that foreign direct investment benefits Canada by helping to spread the strengths of Canadian firms over markets larger than the domestic economy offers. If such firm-specific advantages are generated by research and development expenditures, the costs can be spread over a larger volume of sales. Similarly, following Rugman and McIlveen, firm-specific advantages of a more intangible type, embodied in management or marketing skills, can be spread on a wider base.[3]

Second, Globerman argues that foreign direct investment complements exporting, rather than displacing it.[4] Tariff and nontariff barriers to trade deny exports, so that a Canadian firm would lose its markets unless direct investment reopens the foreign market.

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[1]See G.D.A. MacDougall, "The Benefits and Costs of Private Investment from Abroad: A Theoretical Analysis," *Economic Record* 36 (1960): 13–35.
[2]Steven Globerman, "Direct Investment, Economic Structure, and Industrial Competitiveness: The Canadian Case," in John H. Dunning, ed., *Multinational Enterprises, Economic Structure and Industrial Competitiveness* (London: John Wiley, 1985).
[3]Alan M. Rugman and John McIlveen, *Megafirms: Strategies for Canada's Multinationals* (Toronto: Methuen, 1985).
[4]Globerman, "Direct Investment."

Table 14
Canadian Affiliates in the United States: Selected Economic Data, 1982

	Amount[a]	Percentage of world activity in U.S.[b]
Total assets	91,786	19.4
Sales	64,934	12.6
Net income	−490	–
Employee compensation	13,396	21.6
Number of employees	457,989	18.8
Land owned[c]	2,943	20.8
Mineral rights owned & leased[c]	32,066	43.4
Gross book value of property, plant & equipment	57,040	25.5
Expenditure for new plant and equipment	7,763	26.9
U.S. exports shipped by affiliates	4,262	7.1
U.S. imports shipped to affiliates	6,179	7.3
Income taxes	32	0.6
R&D expenditures	1,047	27.9

[a]All monetary amounts are in U.S.$ millions.
[b]That is, column 1 as a percentage of all foreign-based affiliates in the United States.
[c]In thousands of acres.

Source: United States, Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States: Annual Survey Results*, preliminary 1982 estimates (Washington, D.C., December 1984).

The last argument can be extended to jobs. Many people think of Canadian outward investment as involving a transfer of jobs from Canada to the United States. However, the jobs in Canada might have been lost anyway once exporting was denied to the Canadian firm. Substituting outward regains market access and, once profits are remitted, contributes to Canada's welfare by stimulating its wealth and, thus, its demand for labor in an indirect manner.

The remittances involved are not inconsiderable. The dividends, royalties, and fees earned on Canadian direct investment in the United States during the 1984–85 period were about 5 percent of its position, and the return was over U.S.$1 billion in 1983 alone.[5]

Given these observations, it is useful here to outline some of the more interesting aspects of the rise in Canadian direct investment in the United States. According to the annual survey of affiliates conducted by the U.S. Department of Commerce, in 1982 Canada had a total of 1,373 affiliates in the United States with total sales of nearly U.S.$65 billion.[6] These

[5]United States, Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States: Annual Survey Results*, preliminary 1982 estimates (Washington, D.C., December 1984).
[6]Ibid.

Table 15
Employment of Nonbank U.S. Affiliates, 1980–82
(as a percentage of total employment)

	1980	1981	1982
Canada	14.3%	18.1%	18.8%
France	10.1	9.0	7.9
West Germany	18.5	15.6	14.4
Netherlands	9.2	9.2	9.2
United Kingdom	21.1	21.3	22.0
Switzerland	7.6	6.4	7.1
Europe	72.6	67.4	66.8
Japan	5.7	5.7	5.7
Australia, New Zealand, and South Africa	1.4	2.0	2.1
Latin America	3.7	3.1	3.3
Middle East	1.1	1.5	1.2
Other Africa, Asia, and Pacific	0.6	0.7	0.7
United States	0.6	1.5	1.4

Note: The allotment of affiliates to countries in this table is by ultimate beneficial owner.

Sources: *Survey of Current Business* (U.S. Department of Commerce), various issues; and U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States: Annual Survey Results*, preliminary 1982 results (Washington, D.C., December 1984).

firms employed 457,989 U.S. workers and they spent some U.S.$14 billion on employee compensation. (See Table 14, which also presents other data on these affiliates.) To keep these figures in perspective, recall that the total number of employees in Canada's U.S. affiliates is less than 5 percent of total employment in Canada.

Clearly, Canada's large and growing stock of existing direct investment is socially beneficial to the United States. For example, it accounted for nearly one-fifth of U.S. workers employed in all foreign-owned affiliates in 1982. As Table 15 indicates, in the same year Canada's direct investments were more than three times as job-intensive as Japan's and had significantly increased their share of the total — from 14.3 to 18.8 percent — in two years. In contrast, employment in Dutch-owned affiliates remained constant at 9.2 percent of the total over the same two years, while employment in U.K.-owned affiliates increased only marginally to 22 percent.

In brief, Canadian direct investment in the United States brings benefits to both countries. Although Canada may suffer some social loss of tax receipts, a great deal of wealth is created and sizable amounts of it are returned. Both countries benefit from the spread of expertise and enlarge-

ment of markets. Employment grows in the United States. Yet, the job-intensive nature of Canadian direct investment is not a social loss to Canada since the jobs would not have existed had the Canadian multinationals not secured access to the U.S. market; instead, foreign competitors would have captured it.

Canadian and U.S. Regulation of Foreign Investment

An interesting and important difference between Canada and the United States lies in their approaches to regulation of direct investment. This difference, which provides an indication of how policymakers have evaluated the benefits and costs of direct investment, has historical roots. Canada, with more than 40 percent of its manufacturing sector foreign owned, has regulated foreign investment by a screening process, while the United States, with huge domestic markets and relatively little inward foreign investment, has followed a national treatment approach. The changing pattern of investment may result in changes in policy by either country or both.

Canadian Policy toward Foreign Direct Investment

In 1974, concern in Canada over foreign ownership of its economy led to the creation of the Foreign Investment Review Agency (FIRA). This government agency had the political power to screen, on economic grounds, all inward investment to see if it was of "significant benefit" to Canada.

The checkered career of FIRA has been the subject of detailed analysis.[7] In its 11 years of existence (1974–85), the agency, although perceived as a strong barrier to inward investment, moved from a fairly routine assessor during the 1974–79 period, to a tough barrier during the 1980–81 period,[8] and back to a paper tiger in its last three years. Throughout this time, the somewhat arbitrary nature of FIRA's mandate and its susceptibility to the prevailing political climate led to a strong negative reaction in the United States. Eventually, it became clear that Canada could not afford to ignore the realities of global competition and investment patterns. On July 1, 1985, FIRA was abolished and replaced by Investment Canada, an agency designed to promote inward investment, not to inhibit it.

Although Investment Canada no longer screens most foreign acquisitions, it retains some powers to review them. It also continues to screen

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[7]Alan M. Rugman, *Multinationals in Canada: Theory, Performance and Economic Impact* (Boston: Martinus Nijhoff, 1980), Chapters 9, 10; idem, "Canada: FIRA Updated," *Journal of World Trade Law* 17 (July-August 1983): 352–354; Christopher C. Beckman, *The Foreign Investment Review Agency: Images and Realities* (Ottawa: Conference Board of Canada, November 1984); and A.E. Safarian, *FIRA and FIRB: Canadian and Australian Policies on Foreign Direct Investment* (Toronto: Ontario Economic Council, 1985).

[8]In this period, when Herb Gray was the minister responsible for FIRA, the ratio of unsuccessful applications doubled to nearly 30 percent (see Rugman, "Canada: FIRA Updated").

foreign investment in culturally sensitive areas, as well as indirect acquisitions — those arising from a third-party takeover of a foreign parent firm — when the Canadian assets acquired exceed $50 million. Moreover, although Investment Canada has streamlined the process of investment review, it is still required to seek commitments from foreign investors about export performance, employment, and other factors. Also, the undertakings made in the past to FIRA still remain on Investment Canada's files, so these considerations may still influence corporate behavior and expectations.

Thus, U.S. antipathy toward the regulation of foreign investment in Canada is not fully resolved. Probably only the complete abolition of Investment Canada would satisfy U.S. investors, but such an action might be politically unacceptable to the Canadian people.

In general, Canada's policy toward foreign direct investment remains ambiguous. The current federal government states that Investment Canada wishes to attract foreign investment, yet many tools for screening direct investment remain ready for use, and the principle of national treatment for foreign investors has not been accepted. Many Canadians still harbor doubts about foreign-owned firms, fearing that they will compromise national sovereignty, culture, and independence. The battle for the hearts of Canadians rages on, even when their minds seem to have moved to accept the evidence on the economic benefits of foreign direct investment.

U.S. Policy toward Foreign Direct Investment

The position of the United States government has been that foreign direct investment provides substantial benefits to the U.S. economy and that market-determined forces should govern both inward and outward investment decisions.

A statement by the president in 1983 contained the following key principles of U.S. policy:

- "The United States believes that international direct investment flows should be determined by private market forces and should receive nondiscriminatory treatment consistent with the national treatment principle."
- "Such private foreign direct investment leads to more efficient international production and thereby benefits both home and host countries."
- "Foreign direct investment provides substantial benefits to the United States."
- "The United States opposes the use of government practices which distort, restrict, or place unreasonable burdens on direct investment."
- Exceptions to "fair, equitable and nondiscriminatory treatment" are

made "only as are necessary to protect U.S. security and related interests."[9]

This view of the U.S. administration has been reflected in a policy environment that is, in general, nondiscriminatory between inward investment and domestic investment. In contrast to Canada's aggressive and discretionary screening policy,[10] U.S. policies are defensive and nondiscretionary.

Nevertheless, some barriers to foreign direct investment exist, including laws and regulations at both the federal and state levels. It is a fact, though not well known, that a system of reviewing inward investment has been in place since 1975. And on several recent occasions, there have been calls for more stringent application of restrictions.

Barriers to Investment in the United States

Despite the United States' lack of formal screening procedures, foreign direct investment there is not unfettered. For example, there exist several U.S. federal statutes that restrict inward investment, mainly in such sectors as shipping, maritime activities, airlines, aeronautics, communications, banking, insurance, nuclear and hydroelectric energy, and mineral resource operations on federal lands.[11] Foreign-owned firms and their U.S. affiliates are generally precluded from contracting with the U.S. Defense Department, although the Canadian-U.S. joint defense production-sharing agreement provides some exemption from this restriction. A number of other NATO countries also are able to bid on portions of U.S. defense procurement. Many of the U.S. states do not permit foreign ownership of land, although there is no specific federal prohibition of land and agricultural investments. It is possible that specific regulations affecting foreign investment might be enacted if the percentage of inward investment in

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[9]Ronald Reagan, Statement by the President, United States, Executive Office of the President, Washington, D.C., September 9, 1983; quotations selected and rearranged.

[10]Lorraine Eden, "Review of A.E. Safarian's 'Governments and Multinationals: Policies in the Developed Countries,'" *Canadian Public Policy* 11 (June 1985): 261–264.

[11]The "plethora of laws, regulations, agencies, hearings, programmes and ordinances at both the state and federal levels" were documented in Canada, Foreign Investment Review Agency, "Barriers to Foreign Investment in the United States" (staff document of the Policy, Research and Communications Branch, Ottawa, 1982, Mimeographed). This 72-page staff document gained some notoriety in 1982 when it was informally circulated in media and academic circles at a time when FIRA was under pressure to relax its screening of U.S. and other inward investment into Canada. The thrust of the document is the thesis that the United States does not really maintain an open policy toward incoming foreign investment since it has sufficient regulations and devices to protect its national interest against any it does not want. The case of the cable television industry is cited as an example of U.S. opposition to foreign investment.

Safarian criticizes the FIRA document by noting that it lists all the barriers to business investment in general, not just barriers to foreign investments (see A.E. Safarian, *Governments and Multinationals: Policies in the Developed Countries*, BNAC 33 [London: British-North American Committee, 1983], p. 35).

such sectors was to increase in future years from its current extremely modest level.

Another practical barrier is the plethora of laws and regulations, federal and state, encountered by any foreign firm with operations in the United States. As noted in Chapter 3, Gandhi reports that many small Canadian firms moving into New York have been frustrated by the web of requirements.[12] One suspects that similar problems confront the managers of large firms, but the burden is greatest for small ones.[13]

Investment Review by CFIUS

Other informal barriers, actual and potential, also restrict foreign direct investment in the United States. In May 1975, an executive order established the Committee on Foreign Investment in the United States (CFIUS), an interagency group whose responsibilities are to review and coordinate the implementation of U.S. policies on inward foreign direct investment.[14] So far, CFIUS has been principally occupied with arranging advance consultations with foreign governments concerning proposed inward investment by state-owned enterprises. It also reviews foreign investment that may have implications for U.S. national interests — for example, in the areas of security, defense, and exports of sensitive high-technology products by foreign-parent multinationals to Eastern bloc countries. CFIUS is also responsible for the analysis of trends in foreign direct investment (a function implemented by the Department of Commerce)[15] and for considering proposals for new legislation or regulations relating to inward foreign direct investment.

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[12]Prem Gandhi, "Foreign Direct Investment and Regional Development: The Case of Canadian Investment in New York State" (State University of New York, Center for Business and Economics, Plattsburgh, 1984, Mimeographed).

[13]My own impression from reading the FIRA document ("Barriers to Foreign Investment in the United States") is that any foreign investor seeking entry to the United States should engage the services of the best legal advisors available to steer a course through the web of U.S. regulations that could be used as effective obstacles to foreign investment.

[14]The committee consists of representatives at the assistant secretary level from six departments of the executive branch: Treasury, Commerce, State, Defense, the Council of Economic Advisors, and the Office of the U.S. Special Trade Representative. Other agencies that have participated when their interests were affected include: Agriculture, Energy, Interior, Justice, the Federal Trade Commission, and the Securities and Exchange Commission.

[15]The program of monitoring foreign direct investment by the Office of Trade and Investment Analysis of the International Trade Administration (ITA) of the U.S. Department of Commerce was established by an executive order on May 7, 1975 to fulfill the responsibilities of the *International Investment and Trade in Services Survey Act*. As described in Chapter 3, the ITA monitoring program collects information on all publicly known individual foreign direct investments in the United States; it also supports the review activities of CFIUS. Thus, ITA routinely refers to CFIUS all "transactions with political implications for U.S. national interests," including acquisitions in the energy and high-technology industries and investments by foreign state-owned enterprises (see United States, Department of Commerce, International Trade Administration, Office of Trade and Investment Analysis, *Foreign Direct Investment in the United States Completed Transactions, 1974-1983*, vol. 1, *Source Country* [Washington, D.C., June 1985]).

Reflecting the relatively minor nature of foreign ownership in the U.S. economy, CFIUS has kept a very low profile so far. For example, Safarian reports that it met only ten times during its first six years.[16] More recently, it has reviewed some 10 to 15 cases a year. It has never turned down a proposed investment.[17]

Nevertheless, it is clear that informal discussions with foreign governments and private multinationals could lead to second thoughts about specific inward investments in times of major U.S. concern about foreign ownership.[18] Although CFIUS appears to be a pussycat since it has no formal powers, it can make recommendations directly to such cabinet committees as the National Security Council and the Economic Policy Council. A potential negative decision on an investment could then be implemented through the use of existing legislation residing in antitrust laws, requirements of the Securities and Exchange Commission, national security considerations, and related federal powers. Thus, the potential power of CFIUS cannot be ignored.

In brief, CFIUS so far has been mainly an observer of inward investment in the United States. It has been responsible for the generation of better information about the size and nature of that investment, and it has met to consider sensitive investments, especially those involving foreign governments. The gateway for foreign investment into the United States is still open. Yet, a door, by its very nature, can be closed. CFIUS has the potential to become a very effective gatekeeper if economic conditions change and the United States wishes to impose restrictions on inward direct investment.

The Future of U.S. Investment Policy

The official hands-off approach of the U.S. government to inward investment has been maintained in the face of occasional outbursts of anguish from Congress and sectoral interest groups affected by particular foreign

[16]Safarian, *Governments and Multinationals.*

[17]Investments known to have been reviewed by CFIUS include Royal Dutch/Shell's acquisition of Belridge Oil in 1979; Seagram's acquisition of 25,000 shares of Conoco, which gave the Bronfmans a 20 percent stake in Du Pont after the latter won the takeover battle for Conoco in 1981; Nippon Kokan's proposed acquisition of Kaiser Steel; Elf-Aquitaine's merger with Texasgulf in 1981; investments involving the national petroleum agencies of Iran and Kuwait, including the latter's proposed investment in Getty Oil and its eventual merger with Santa Fe; a Romanian investment in an Island Creek coal mine; Renault's acquisition of American Motors; and other such cases involving government-owned firms. Also reviewed were the government of Iran's proposed acquisition of Occidental Petroleum, which fell through, and the transfer of Texasgulf's Canadian assets to the Canada Development Corporation.

[18]The Texasgulf case appears to be an example of CFIUS using its review procedure to defer a foreign investment (although it was not formally rejected). CFIUS argued that the transfer of Texasgulf's assets to a Canadian crown corporation would have adverse effects on the availability of sulfur and phosphate fertilizer in the United States (see "U.S. vs. Canada: Ominous Developments for Foreign Investors," *Business International*, July 24, 1981, p. 237).

investments. In the 1970s, concern was expressed over potential large direct investments by members of the Organization of Petroleum Exporting Countries.[19] In the early 1980s, groups in the energy and other sectors affected by Canada's National Energy Program and the stringent screening of FIRA demanded reciprocal action against Canadian inward investment. These tensions were reduced in the fall of 1982 when Herb Gray was replaced as the minister responsible for FIRA and the realities of the recession forced Canada into a recognition of the value of foreign investment.

During the critical 1980–81 period, the U.S. executive agencies managed to maintain their position of neutrality toward inward investment — a signal that U.S. policy toward Canadian foreign direct investment can ride out temporary bilateral economic problems. The executive branch of the U.S. government has also demonstrated the capacity to keep regional and sectoral considerations in perspective. For example, congressional and state attempts to extend restrictions on the sale of real estate and farmland in U.S. regions with a significant amount of foreign ownership have not been successful.[20] Similarly, lobbying by companies involved in takeover attempts by Canadian and other foreign multinationals, especially in the early 1980s, has not resulted in specific U.S. restrictions being imposed. Finally, U.S. labor unions have not yet pursued any major programs against inward investment, perhaps accepting the argument that it creates jobs.

Nevertheless, Congress partners the executive branch in the making of economic policy, and some state-level politicians have considerable, if informal, influence.

Congressional leaders have not been as concerned with investment policy as they have with trade policy (Congress merely delegates authority to the president to negotiate on trade matters) because many of their constituents, lobby groups, local and state governments, industry associations and unions, strongly encourage inward investment, especially for the jobs and incomes which result. However, some of these leaders have recently worried about foreign ownership of the United States.

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[19]In fact, most of the oil money was recycled into financial capital via the Eurocurrency markets.

[20]Americans can be just as nationalistic as Canadians in their perceptions of foreign ownership. For example, 30 U.S. states impose restrictions on the foreign ownership of farmland, by corporations or individual investors. Yet foreigners hold only about 1 percent of all privately held farmland in the United States. Laband estimates that it would take at least another 20 years for foreigners to double their holdings of U.S. farmland, since they purchase only about 2 percent of all farmland sold annually in the United States. Of the 13.5 million acres owned by foreigners, only 13 percent is cropland; 55 percent is forest, and 27 percent is pasture or for other uses. For the most part, non-U.S. owners hold this land in partnership with U.S. corporations; only 37 percent of the acreage is owned by foreign investors alone (see David N. Laband, *Foreign Ownership of U.S. Farmland* [Lexington, Mass.: D.C. Heath, 1984]).

For example, Senator Frank Murkowski of Alaska said in late 1985: "Once they own your assets, they own you. They employ you."[21] Similarly, Senator Lloyd Bentsen of Texas stated: "You get an immediate reaction when you introduce a piece of legislation that affects these foreign investors in the United States....They don't just stop at the Washington level. You hear from their distributors and contractors back home right away." But, he continued: "I do not think foreign nationals have any business in our political campaigns....Their loyalties lie with their own countries and their own governments."[22]

Governor Richard D. Lamm of Colorado sounds even more nationalistic. He stated at the 1985 meeting of the National Governors Association: "I do not want the Japanese coming in and buying up American technology. I do not want them in our state. I don't want the Arabs owning our banks or the Japanese owning our means of production."[23]

Canadian nationalists have long made similar statements about U.S. foreign ownership of Canadian industry. However, xenophobic statements may have less influence on U.S. policy than such thinking has in Canada. The U.S. has a liberal policy toward foreign investment, and this policy direction appears likely to be maintained in the face of any future congressional attempts to link restrictions on foreign investment with the thrust toward restricting trade by applying the trade remedy laws administered by the U.S. International Trade Commission.[24]

Summary

The conclusion to this section on U.S. policy toward foreign investment must be one of caution. On the one hand, the U.S. government officially invites inward investment, and the door does appear to be particularly wide open for investment from its friendly Canadian neighbor. On the other hand, it is not a particularly difficult task to come up with a list of practical barriers to direct investment in the United States.[25] Although these

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[21] *New York Times*, December 30, 1985.

[22] Ibid.

[23] *Globe and Mail* (Toronto), February 27, 1985.

[24] Alan M. Rugman and Andrew Anderson, *Administered Protection in America* (New York: Methuen; London: Croom Helm, 1987).

[25] See, for example, "Are Foreign Multinationals Excluded from Entering the U.S. by Takeover?" *Multinational Business Quarterly* (London, the Economist Intelligence Unit), no. 4, December 1985; and Canada, Foreign Investment Review Agency, "Barriers to Foreign Investment in the United States."

For a more sanguine assessment of U.S. restrictions, see Harvey E. Bale, "The U.S. Federal Government's Policy Towards Foreign Direct Investments," in Earl H. Fry and Lee H. Radebaugh, eds., *Regulation of Foreign Direct Investment in the United States* (Provo, Utah: Brigham Young University, 1985), pp. 29–46. He says that basic U.S. policy is one of national treatment of foreign investors, which implies the general absence of barriers to inward investment. Some U.S. federal and state laws may represent departures from national treatment, such as those concerning air transportation, ocean and coastal shipping, *(continued)*

barriers are in the form of a set of diffuse laws, regulations, and hearings procedures, rather than a formally mandated screening agency, such informal mechanisms can still act as a barrier to direct investment. These informal powers of delay are more a hindrance to smaller investors than to the larger Canadian multinationals, which are better versed in the U.S. legal and political environment. Given the relatively low degree of foreign ownership in the United States, it is unlikely that direct investment will ever become the issue in the United States that it has been in Canada. Nevertheless, the United States, like Canada, has in place mechanisms that can respond to the political climate. Moreover, the removal of existing practical obstacles to foreign direct investment is a challenge yet to be taken up by U.S. federal agencies and state governments.

Trade and Investment Policy Linkages

Policy toward international direct investment cannot be separated from policy toward trade, because firms view investment as an alternative to exporting. Once a firm finds that it cannot supply a foreign market by exports because a government has imposed tariff or nontariff barriers to trade, it has the option of switching to direct investment to retain access to that market.

Sometimes managers have a third option: entering into a contractual arrangement with a firm in the host country, under a licensing or joint venture agreement. In most such arrangements, the multinational brings technical production knowledge or management skills to the agreement while the host-country partner or licensee brings either capital or knowledge about the host country's economic environment and political system.

Canadian firms are unlikely, however, to have many reasons for licensing agreements since most Canadian business is in mature or resource-based sectors where products are fairly standardized and the firm-specific advantages often lie at the marketing end, which are unlikely to be separable from the overall operations of the firm. For a similar reason, joint ventures are less attractive alternatives than direct investment. The data appear to indicate that direct investment — through acquisitions, mergers, and equity stockholding — is more common than nonequity forms of

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[25]Continued . . .
banking, insurance, nuclear energy, mineral resource exploration on federal lands, fishing, broadcasting, cable television, and so on. Bale argues, however, that these restrictions have little practical effect and that foreign interests have managed to make substantial investments in some of these sectors. He states that such relatively simple devices as incorporation in the United States can avoid many of the formalities. Bale also argues that U.S. antitrust and securities laws are not really barriers to foreign investment as they are applied on a nondiscriminatory basis — that is, the principle of national treatment holds in these areas.

foreign investment for Canadian firms going abroad (see Table 13 in Chapter 3).

Given this background, one can argue that the recent upsurge in Canadian direct investment into its major market, the United States, reflects increasing protectionism in that country. There is indeed some evidence of an increase in U.S. nontariff barriers, in particular through the contingent protection administered by the U.S. International Trade Commission and the Department of Commerce.[26] The escalation of such administered protection, however, has occurred only in the past few years. Moreover, the increase in Canadian direct investment appears to be matching that of other major capital exporting countries and to be part of a general trend among multinationals toward cross investments in each other's home markets. Thus, one can also argue that policy toward direct investment should be governed by an attempt to understand the linkage of investment to trade policy and the interdependence of global economic relations.

Bilateral Trade and Investment Policies: Canada

In September 1985, the Mulroney government asked President Reagan to begin a new set of bilateral trade negotiations aimed at securing and enhancing market access to the United States for Canadian traders. This freer trade initiative has implications for policy in terms of the future status of both U.S. direct investment in Canada and Canadian outward investment to the United States. The impact of a comprehensive — or partial — trade agreement in these two areas is the subject of ongoing research.[27]

Such studies show that any adjustment of direct investment flows would be a gradual one, since it is in the self-interest of multinational enterprises to smooth out internal restructuring in response to a new trading environment. Indeed, multinationals have organizational structures already in place to minimize restructuring costs and to seize new opportunities. Considerable restructuring has occurred in response to the reductions of tariffs between Canada and the United States as a result of successive rounds of tariff reduction and in response to increased competition from offshore producers. Therefore, the introduction of a freer trading system would have less of an adverse impact on jobs, production, and other activities of multinationals than many people fear. Moreover, further restructuring of

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[26]Alan M. Rugman, "U.S. Protectionism and Canadian Trade Policy," *Journal of World Trade Law* 20 (July-August 1986): 363-380.

[27]See A.E. Safarian, "The Relationship between Trade Agreements and International Direct Investment," in David W. Conklin and Thomas J. Courchene, eds., *Canadian Trade at a Crossroads: Options for New International Agreements* (Toronto: Ontario Economic Council, 1985), pp. 206-221; D.F. Burgess, "The Impact of Trade Liberalization on Foreign Direct Investment Flows," in John Whalley and Roderick Hill, eds., *Canada-United States Free Trade*, vol. 2 (Toronto: University of Toronto Press, 1985), pp. 193-199; and Alan M. Rugman, *Trade Liberalization and International Investment* (Ottawa: Economic Council of Canada, forthcoming).

production within multinationals, once government barriers to trade were removed, could yield significant productivity gains.

Bilateral Trade and Investment Policies: The United States

The United States has kept its door open to inward direct investment; Canadians recently have rushed in. To some extent, the United States can afford to predicate its investment policy on efficiency grounds, since foreign ownership of its economy is only about 3 percent of its GNP. One result is that there is relatively little political pressure directed against foreign control. Furthermore, inward investment does not threaten U.S. culture, as is sometimes thought to be the case in Canada.

From Canada's viewpoint, the greatest danger to its outward investment in the United States would come from a new administration that believed in a new industrial policy for the United States. Such a policy inevitably would have strong protectionist elements, and it might impose restrictions on foreign direct investment inflows, such as national purchasing requirements, as well as more restrictive U.S. trade laws.

U.S. business scholars, having become aware of the challenge from Japan and the newly industrialized countries, have considered arguments for state support of business through an explicit industrial strategy.[28] Although such concerns are driven by trade considerations — in this case, analysis of loss of market share in the high-technology sectors — the implementation of any type of industrial policy by the United States would have major effects on direct investment patterns.

The first best policy toward direct investment is to have freer trade. A Canadian-U.S. comprehensive trade agreement would guarantee entry to the U.S. market for Canadian firms; in particular, it would exempt them from the nontariff barriers imposed by the current administration of U.S. trade laws. Freer trade would also offer gains to the economic welfare of both countries — consumer benefits that are too often neglected in studies of bilateral economic relations.[29]

Yet, if freer trade is not achieved — and the implementation of agreements to reduce nontariff barriers will be extremely difficult to realize — Canadian firms can still enter the U.S. market by the back door of direct investment. Canadian policymakers are likely to strive to keep this door open while attempting to convince their U.S. counterparts of the long-term mutual benefits of freer trade. It is also in the best interest of the United States to foster a favorable climate for trade liberalization and unimpeded

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[28]See, for example, Bruce R. Scott and George C. Lodge, eds., *U.S. Competitiveness in the World Economy* (Boston: Harvard Business School Press, 1985).

[29]Although not in the studies commissioned by the Royal Commission on the Economic Union and Development Prospects for Canada (the Macdonald Commission); or in Richard G. Lipsey and Murray G. Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation 27 (Toronto: C.D. Howe Institute, 1985).

inward direct investment in order to exhibit leadership to other countries in which trade restrictions and foreign ownership are more of a domestic political issue.

Conclusion: Global Reality and Bilateral Economic Relations

The linkages of trade and investment decisions have a bearing on other aspects of Canadian-U.S. bilateral economic relations. Consider Morici's framework, in which both Canada and the United States are now recognized as being vulnerable to intense international competition, especially from Japan and the newly industrialized countries of Southeast Asia.[30] As key players in the global marketplace of the 1980s, Canada and the United States can only strengthen their relative positions by the free movement of direct investments.

As Canadian direct investment inflows to the United States increase relatively faster than U.S. direct investment into Canada, the two countries achieve a better balance. Investment flows come more into line with trade patterns, where historically there has been approximate long-run equilibrium in the bilateral payments accounts.[31]

The closer balance of outward and inward direct investment may also help Canadians to resolve some of their lingering concerns about foreign ownership. The Canadian fear of U.S. domination of domestic cultural and political affairs may be softened by the knowledge that Canada now has a big stake in its neighbor. Meanwhile, the combined weight of direct investment in the United States from many countries ultimately may serve to make U.S. citizens more aware of the two-way nature of capital flows and perhaps more sensitive to concerns about foreign ownership in small, open trading economies such as Canada.

At the very least, the greater degree of interpenetration of each others' economies should eventually help Canadians and Americans to reduce the type of bilateral tensions Leyton-Brown identifies in his analysis of Canada's National Energy Program.[32] As foreign direct investment continues to grow, it should become more apparent to all players that the U.S. and Canadian economies are strongly linked and that the elements of mutual interest are stronger than those of economic rivalry.

Some Canadian observers may see a problem in such integration of the U.S. and Canadian economies; they would prefer diversification of Canada's trading patterns. Unfortunately, Canada's attempts to diversify trade,

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[30] Peter Morici, *The Global Competitive Struggle: Challenges to the United States and Canada*, CAC 50 (Washington, D.C.; Toronto: Canadian-American Committee, 1984).

[31] The main exception was the 1981–85 period, when the U.S. overall capital account surplus was matched by a trade account deficit with Canada. This situation can be largely explained by the U.S. dollar appreciation caused by massive inflows of short-term capital attracted by the large real interest rate differential in favor of the United States in the early 1980s.

[32] David Leyton-Brown, *Weathering the Storm: Canadian-U.S. Relations, 1980–83*, CAC 51 (Toronto; Washington, D.C.: Canadian-American Committee, 1985).

stemming from Mitchell Sharp's "Third Option" of a dozen years ago, have met with conspicuous failure. Today, Canada's trade is concentrated on the United States more than ever before. Since Canada appears to have been unsuccessful in export diversification into other world markets, it is imperative that access to the U.S. market be maintained by direct investment, especially in a period of growing U.S. protectionism. As Canada's multinationals continue to mature, they may eventually become vehicles for the global diversification that Canadian trade policy has so far failed to secure.

The upsurge of Canadian outward investment detailed in this study demonstrates that private corporations can and do respond to market imperfections and government-imposed barriers to trade. The success of Canada's multinationals in penetrating the U.S. market suggests that Canadian managers are able to meet the challenges of global rivalry. Today, Canadian outward direct investment serves to foster greater interdependence of the economies of the United States and Canada in an era of ever-increasing global competition.

It would, of course, be helpful to business investment decisions if bilateral trade and investment policies could achieve a greater degree of predictability than we have witnessed over the past decade. Greater certainty in the policy environment, perhaps secured through a comprehensive bilateral trade agreement, would consolidate both investment and trade patterns to the mutual advantage of the United States and Canada. The challenge for policymakers is to seek out and implement workable economic policies of long-term mutual benefit in the face of immediate domestic political pressures on both sides of the border.

Appendix A: Technical Issues in Data Measurement

In the course of this study, it became clear that substantial methodological issues remained unresolved in the treatment of Canadian outward investment by the statistical agencies responsible for such data collection and dissemination. The data produced by Statistics Canada and the U.S. Department of Commerce on Canadian direct investment in the United States are not directly comparable, and extreme care must be exercised when moving from one data source to another. This appendix addresses several of the more important problems, especially as they may affect policy interpretations.

Reconciling the Data on Direct Investment

The magnitude of the problem is apparent in Table A-1, which reports data for the past 11 years. For 1980, the Department of Commerce reports the Canadian stock of foreign direct investment at just over U.S.$12 billion, while Statistics Canada reports a figure of more than Can.$16 billion. If adjustment is made for the exchange rate, as in Table A-2, the Department of Commerce figures would be Can.$14,530 million, leaving a difference of over $1.5 billion. Since 1980, the divergence has increased rapidly, even allowing for exchange-rate adjustments.

One problem is the Department of Commerce's method of extrapolating data forward from a fixed benchmark survey, using only sample data for the interim years. Such extrapolation can lead to large discrepancies. For example, global direct investment in the United States for 1980 was measured at U.S.$14,695 million more than use of the 1974 benchmark had yielded for the same year — a difference of more than 21 percent. Unfortunately, the latest available benchmark survey, published in October 1983, uses 1980 operating data.[1] Statistics Canada, on the other hand, takes an annual census survey of Canadian enterprises investing abroad.

The potential statistical discrepancy is in addition to that resulting from any of the other causes outlined below.[2]

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[1]United States, Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States, 1980* (Washington, D.C., October 1983).

[2]See R. David Belli, "Foreign Direct Investment in the United States in 1983," *Survey of Current Business* (U.S. Department of Commerce), October 1984, pp. 26–48.

Table A-1
Canadian and U.S. Estimates of Canadian Direct Investment Position in the United States, 1975–85

	U.S. figures (U.S.$ millions)	Growth rate (%)	Canadian figures (Can.$ millions)	Growth rate (%)
	(1)	(2)	(3)	(4)
1975	$5,352	4.2%	$5,559	16.6%
1976	5,907	10.4	6,092	9.6
1977	5,650	−4.4	7,116	16.8
1978	6,180	15.8	8,965	26.0
1979	7,154	16.0	12,063	34.6
1980	12,162	70.0	16,386	35.8
1981	11,870	−2.4	21,831	33.2
1982	11,435	−3.7	23,137	6.0
1983	11,434	0.0	25,528	10.3
1984	15,286	33.7	29,932	17.3
1985	16,678	9.1	35,474	18.5
Average, 1975–85		13.5		20.4

Sources: *Survey of Current Business* (U.S. Department of Commerce), various issues; U.S. Department of Commerce, *News*, BEA 85-33, Washington, D.C., June 1985; Statistics Canada, *Canada's International Investment Position*, Cat. no. 67-202, various issues. Data for 1981–85 is from Statistics Canada, International and Financial Economics Division.

Tax Havens

A critical explanation for the discrepancy is the two agencies' differing treatment of investment that flows through tax havens. The Department of Commerce data attribute a foreign direct investment to the country from which it most immediately flowed, even if that country is a tax haven and the source of the investment is Canadian — or even American.[3] The department does this to maintain consistency with its annual balance of payments data, which it prepares without always being able to identify the "ultimate beneficial owner" of the capital. For the quite separate data series used for benchmark surveys, the Department of Commerce does obtain balance sheet and income statement data from the entire population of subsidiaries in the United States and applies the concept of "ultimate beneficial owner" to define a foreign direct investor.[4] As already noted,

[3]Ibid., p. 27, note 4.
[4]The Department of Commerce defines an

> ultimate beneficial owner (UBO) as that person, proceeding up a U.S. affiliate's ownership chain beginning with and including the foreign parent, that is not owned more than 50 percent by another person. The UBO consists of only the ultimate owner; other affiliated persons are excluded. If the foreign parent is not owned more than 50 percent by another person, the foreign parent and the UBO are the same. However, a UBO, unlike a foreign parent, may be a U.S. person. Both the foreign parent and the UBO are 'persons' in the broad sense.

An associated group is said to be a person (United States, Department of Commerce, *Foreign Direct Investment*, p. 4).

however, these surveys are infrequent.

On the other hand, Statistics Canada has a keener analysis of each individual transaction in its annual statements of Canada's investment position.[5] It makes heroic efforts to trace the original source for a direct investment in the United States, using supplementary information from the financial press and other sources. Thus, investment that the Department of Commerce may attribute to, say, the Netherlands Antilles in its annual balance of payments data is likely to be assigned by Statistics Canada to the original Canadian investor. To see the difference in the results of the two methods, recall the "double dip" tax maneuver described in Chapter 2. The $10 capital inflow to the United States would be attributed to the Netherlands Antilles, not to Canada. Statistics Canada would follow the capital to its ultimate destination.[6]

The difference in results is sizable. For its 1980 data, for example, Statistics Canada reported an adjustment of $5 billion for tax-haven effects, which increased the figures on outward direct investment to capture Canadian money flowing through tax-haven countries and through the Netherlands itself.

The net effect is that the U.S. data understate direct investment from Canada, since some of it is channeled through tax havens. The Statistics Canada data are more reliable in this respect, because of that agency's greater flexibility in its definition of Canadian-owned direct investment. It appears, therefore, that the Statistics Canada treatment of tax havens is a major factor in explaining the difference in the data.

Smaller Firms

Another possible factor in the divergence in the two countries' data is that Statistics Canada provides superior coverage of small and medium-sized firms, which is made possible by its annual survey of Canadian enterprises investing abroad. It has found that such firms have been growing rapidly in recent years as investors in the United States.

The Department of Commerce does not cover smaller firms, and revision to its data is frequent for this reason. Since 1984, it has covered only firms with sales exceeding U.S.$10 million; before then, the cutoff point was U.S.$5 million.

Valuation Factor

Yet another difference between the two countries' statistics on direct

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[5]See Statistics Canada, *Canada's International Investment Position, 1979 and 1980*, Cat. no. 67-202 (Ottawa, 1984).

[6]The problem is compounded by the fact that foreign direct investment from the Netherlands Antilles has only recently been identified as such in the U.S. figures. Before 1980, such investments were attributed to "other Western hemisphere".

Table A-2
Canadian and U.S. Estimates of Canadian Direct Investment Position in the United States, 1975–85, with Adjustments for Exchange Rates

	U.S. Dept. of Commerce figures (U.S.$ millions)	Adjusted Canadian data (U.S.$ millions)	Growth rate of adjustment (%)	Statistics Canada figures (Can.$ millions)	Adjusted U.S. data (Can.$ millions)	Growth rate of adjustment (%)
	(1)	(2)	(3)	(4)	(5)	(6)
1975	5,352	5,469	–	5,559	5,439	–
1976	5,907	6,036	10.3	6,092	5,961	9.6
1977	5,650	6,502	7.7	7,116	6,183	3.7
1978	6,180	7,560	16.2	8,965	7,329	18.5
1979	7,154	10,327	36.6	12,063	8,357	14.0
1980	12,162	13,716	32.8	16,386	14,530	73.8
1981	11,870	18,409	34.2	21,831	14,077	-3.1
1982	11,435	18,820	2.2	23,137	14,058	-0.1
1983	11,434	20,514	9.0	25,528	14,228	1.2
1984	15,286	22,652	10.4	29,932	20,199	50.0
1985	16,678	25,384	12.1	35,474	23,307	15.4
Average, 1975–85	13.7		17.2	20.8		18.3

Note: The exchange rates used are year-end market rate/par or central rate for 1975–85.

Sources: *Survey of Current Business* (U.S. Department of Commerce), various issues; U.S. Department of Commerce, *News*, BEA 85-33, Washington, D.C., June 1985; Statistics Canada, *Canada's International Investment Position*, Cat. no. 67-202, various issues. Data for 1981–85 is from Statistics Canada, International and Financial Economics Division. Exchange rates are from International Monetary Fund, *International Financial Statistics Yearbook 1986* (Washington, D.C., 1986), p. 156.

Table A-3
Canadian and U.S. Methods Used to Define Foreign Direct Investment Stocks, 1980

U.S. Department of Commerce Method

Canadian position	=	Capital stock	+	Retained earnings	+	Unincorporated affiliates	+	Payables to parent	−	Receivables from parent
100%	=	40.9%	+	22.5%	+	10.5%	+	32.8%	−	6.7%
		EQUITY						DEBT (short-term and long-term)		

Statistics Canada Method

Canadian position	=	Capital stock	+	Capital surplus (deficit)	+	Retained earnings	+	Funded debt	−	Other long-term debt
100%	=	28.9%	+	13.9%	+	31.5%	+	3.2%	−	22.6%
		EQUITY						DEBT (long-term only)		

Note: The percentages for the Statistics Canada method are for total Canadian direct investment abroad, while the Department of Commerce numbers are for Canadian direct investment in the United States.

Sources: United States, Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States, 1980* (Washington D.C., October 1983); Statistics Canada, *Canada's Foreign Direct Investment Position 1979 and 1980*, cat. no. 67-202 (Ottawa, 1984).

investment is that the U.S. data include a valuation adjustment, which came out as high as U.S.$2 billion for 1982. This adjustment results from reclassifying certain large transactions to different countries, as happened in 1981 and 1983 when several Canadian investors shifted ownership to holding companies abroad. In 1982, a U.S.$1 billion valuation adjustment was added to Canada's position, nearly all of it because of the sale by the Canada Development Corporation of its 36.9 percent share of Texasgulf to Paris-based Elf-Aquitaine.

Short-Term Debt

An additional factor that may influence the accounts is the two countries' different treatment of short-term debt. Statistics Canada excludes it from the data on direct investment, whereas, since 1980, the Department of Commerce has grouped short-term and long-term debt in one category called intercompany debt flows — previously, it had reported separate figures for these two debt items. The effect on overall data is, however, probably of a fairly minor nature.

A Comparison of Definitions for 1980

Canada and the United States also differ in their calculation of the stock of foreign direct investment. Table A-3 summarizes the two methods, using

Table A-4
Global Stock of Canadian Foreign Direct Investment by Type of Capital, 1975–82

	Capital stock	Capital surplus	Retained earnings	Funded debt	Other long-term debt	Total
			(value in Can.$ millions)			
1975	3,473	1,491	3,734	152	1,676	10,526
1976	3,963	1,683	3,933	270	1,642	11,491
1977	4,597	1,724	4,928	337	1,923	13,509
1978	6,025	2,027	5,739	499	2,132	16,422
1979	5,857	3,103	7,286	748	2,992	19,986
1980	7,559	3,583	8,130	815	5,766	25,853
1981	9,906	5,150	7,742	1,656	8,121	32,578
1982	11,247	6,815	4,891	1,375	9,872	34,200
			(percent)			
1975	33.0	14.2	35.5	1.4	15.9	100
1976	34.6	14.6	34.2	2.3	14.3	100
1977	34.0	12.8	36.5	2.5	14.2	100
1978	36.7	12.3	35.0	3.0	13.0	100
1979	29.3	15.5	36.5	3.7	15.0	100
1980	29.2	13.9	31.4	3.2	22.3	100
1981	30.4	15.8	23.8	5.1	24.9	100
1982	32.9	19.9	14.3	4.0	28.9	100

Sources: Statistics Canada, *Canada's International Investment Position 1979 and 1980*, Cat. no. 67-202 (Ottawa, 1984), Table 12; revised 1979–80 and 1981–82 figures provided by Statistics Canada, International and Financial Economics Division.

data for 1980, the latest date for which Statistics Canada figures have been published.

Both agencies see a country's position as consisting of two basic elements: equity and debt. For the Department of Commerce, equity comprises of capital stock, retained earnings, and the earnings of unincorporated affiliates, while debt is the difference between payables to and receivables from the parent.[7] The Statistics Canada method is to break total capital invested into five categories: capital stock, capital surplus or deficit, retained earnings, funded debt, and other long-term debt. The first three items represent equity; the last two are components of long-term debt. It should be noted that the Statistics Canada method excludes short-term debt.

The main difference in these two methods appears in the treatment of retained earnings, which are nearly 50 percent greater in the Statistics Canada figures than in those of the Department of Commerce for 1980.

[7]Because of changes in the Department of Commerce's handling of unincorporated affiliates in the 1980 benchmark study, only the totals, not the components, of direct investment position, capital flows, and income are comparable with data for those of previous years.

Table A-5
Canadian Retained Earnings Abroad, 1980–82

	Earnings in all countries	Earnings in the United States	Earnings in U.S. as % of total
	(Can.$ thousands)		
1980	$8,123,302	$4,492,289	55.3%
1981	8,836,596	5,070,386	57.4
1982	4,138,666	1,193,702	28.8

Source: Information provided by Statistics Canada, International and Financial Economic Division.

The other equity components are approximately the same, as are the data for debt.

It is not possible to prepare such a comparison for the flow figures, since Statistics Canada reports flow data only in its quarterly balance of payments series, which does not include breakdowns of equity and debt.

Retained Earnings

When a Canadian multinational enterprise earns after-tax profits in the United States that are reinvested in the U.S. subsidiary rather than received as dividends, the resulting additional capital owned by Canadians is not reflected in the Canadian balance of payment statistics. Does the omission of these retained earnings — sometimes called undistributed earnings — affect the reports of relative positions in any significant way?

To answer the question, one must consider that retained earnings are a missing component of the Canadian current account, where dividends would have been recorded as a credit if they had been received, and of the U.S. current account, where dividends taken out by Canadian multinationals would have been recorded as a debit if they had been paid.[8] Since the balance of payment statistics do not incorporate retained earnings, they tend to understate current account inflows to Canada.

Table A-4 illustrates the importance of retained earnings (which were excluded from the flow data in Table 1 in Chapter 1) in the stock of all Canadian direct investment abroad. For the 1975–80 period, retained earnings was the most popular mode of capital investment, accounting for about 35 percent of the total, just ahead of capital stock. The stock of direct investment capital grew steadily over the period. The contribution of each of the five components was fairly stable except for the debt items, which increased more in value and at a greater rate than other forms of foreign direct investment in 1980.

[8]If Canadian subsidiaries in the United States had reported losses, the situation would, of course, have been reversed.

Table A-6
Canadian Retained Earnings by Sector, 1980
(Can.$ millions)

	Earnings in the United States	Earnings in all countries	Earnings in U.S. as % of total
	(1)	(2)	(3)
Petroleum and natural gas	$606	$963	63.0%
Manufacturing	2,628	4,850	54.2
Mining	650	480	135.2[a]
Utilities	154	415	37.1
Merchandise	126	666	18.9
Financial	306	684	44.8
Other	22	66	33.7
Total	*4,492*	*8,123*	*55.3*

[a]Negative retained earnings in other parts of the world made this percentage possible.

Source: Information provided by Statistics Canada, International and Financial Economic Division.

Breakdowns of Canada's retained earnings in the United States, obtained from Statistics Canada, are shown in Tables A-5 and A-6. The first of the pair is a time series. Somewhat more than half of all Canadian earnings retained abroad were in the United States until 1982, when the proportion declined sharply.

Table A-6 shows a sectoral breakdown for 1980. In that year, Canadian investment was strongly focused on the U.S. mining, petroleum and natural gas, and manufacturing sectors; the financial sector, which here includes real estate, came fourth. Data for 1981 show much the same pattern, but in 1982 there were negative values for Canadian retained earnings in the U.S. petroleum and natural gas, mining, financial, and "other" sectors.

What is the impact of retained earnings for this study? Following Safarian,[9] Table A-7 repeats data on direct investment flows, excluding reinvested earnings from Table 1 (columns 1, 4, and 7 here), and then adds in retained earnings. By comparing columns 1 and 3, one sees that inward direct investment is increased substantially by including the retained earnings of U.S. subsidiaries in Canada (column 2), and that for most years through 1980 Canadian multinationals financed part of their U.S. expansion from retained earnings (column 5). In 1972 and 1981–82, Canadian firms drew down their retained earnings from the United States, apparently repatriating their wealth rather than reinvesting it. This reduction in undistributed earnings for 1981 and 1982 may, however, be partly the result of operating losses by the U.S. subsidiaries. The statistical decline

[9]A.E. Safarian, *FIRA and FIRB: Canadian and Australian Policies on Foreign Direct Investment* (Toronto: Ontario Economic Council, 1985), pp. 39–40, Table 9.

Table A-7
Flows and Retained Earnings of Direct Investment to and from Canada, 1960–85
(Can.$ millions)

	Inward			Outward			Net	
	Flow[a]	Change in retained earnings	Total	Flow	Change in retained earnings	Total	Flow (1 – 4)	Total (3 – 6)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1960	$670	$280	$950	$50	n.a	–	$620	n.a
1961	560	240	800	80	n.a	–	480	n.a
1962	505	325	830	105	n.a	–	400	n.a
1963	280	435	715	135	n.a	–	145	n.a
1964	270	480	750	95	n.a	–	175	n.a
1965	535	735	1,270	125	n.a	–	410	n.a
1966	790	640	1,430	5	n.a	–	785	n.a
1967	691	845	1,536	125	n.a	–	566	n.a
1968	590	810	1,400	225	167	392	365	1,008
1969	720	1,045	1,765	370	105	475	350	1,290
1970	905	830	1,735	315	342	657	590	1,078
1971	925	1,335	2,260	230	333	563	695	1,697
1972	620	1,545	2,165	400	–65	335	220	1,830
1973	830	2,165	2,995	770	571	1,341	60	1,654
1974	845	2,730	3,575	810	493	1,303	35	2,272
1975	725	2,553	3,278	915	487	1,402	–190	1,876
1976	–300	2,744	2,444	590	199	789	–890	1,655
1977	475	2,971	3,446	740	995	1,735	–265	1,711
1978	135	3,720	3,855	2,325	811	3,136	–2,190	719
1979	750	4,783	5,533	2,550	1,570	4,120	–1,800	1,413
1980	800	5,442	6,242	3,150	808	3,958	–2,350	2,284
1981	–4,400	3,671	–729	6,900	–350	6,550	–11,300	–7,279
1982	–1,000	1,247	247	1,075	–2,779	–1,704	–2,075	1,951
1983	200	4,700	4,900	2,975	n.a	n.a	–2,775	n.a
1984	2,150	5,300	7,450	3,800	n.a	n.a	–1,650	n.a
1985	–2,450	n.a	n.a	4,900	n.a	n.a	–7,350	n.a

[a]Column 1 is gross inflows minus gross outflows, including in the latter acquisitions of direct investment interests in Canada from nonresidents; a similar interpretation applies to outward flows in column 4. Data from 1980–84 was revised in May 1986.

Sources: Statistics Canada, *System of National Accounts, Quarterly Estimates of the Canadian Balance of International Payments*, Cat. no. 67-001, various issues; and idem, *System of National Accounts, Canada's International Investment Position*, Cat. no. 67-202, various issues.

also reflects Statistics Canada's reclassification of certain Canadian direct investments because of corporate restructuring by several Canadian multinationals.

The inclusion of net undistributed earnings disguises the reversal of net direct investment flows in 1975. Over time, however, the total impact of net capital flows plus the balance of undistributed earnings (column 8) essentially parallels that of net direct investment flows (column 7). In other words, adding in retained earnings changes absolute values and may reverse the direction of a given net flow, but it does not change the relative picture over time. Thus, none of the main conclusions of the text needs to be modified in light of the additional data.

Appendix B:
Statistical Tables

Table B-1
Canadian Foreign Direct Investment Flows, 1927–59[a]
(Can.$ millions)

	Foreign direct investment in Canada[b]	Canadian foreign direct investment abroad	Net flow (1) + (2)
	(1)	(2)	(3)
1927	$49	$–14	$35
1928	40	–19	21
1929	38	–20	18
1930	64	–27	37
1931	31	–21	10
1932	–4	–24	–28
1933	–31	–28	–59
1934	–6	–39	–45
1935	–14	–30	–44
1936	–27	–35	–62
1937	–21	–43	–64
1938	–4	–29	–33
1939	–29	–24	–53
1940–45	n.a.	n.a.	n.a.
1946	40	–14	26
1947	61	6	67
1948	71	15	86
1949	94	13	103
1950	225	35	240
1951	320	–30	290
1952	360	–85	275
1953	450	–70	380
1954	425	–90	335
1955	445	–85	360
1956	650	–105	545
1957	545	–80	465
1958	430	–40	390
1959	570	–85	495

[a]Data exclude reinvested earnings (see text, note 2). A minus sign indicates an outflow of capital from Canada — an increase in holdings of assets abroad or a reduction in liabilities to nonresidents.

[b]Column 1 represents gross inflows minus gross outflows, including acquisitions of foreign direct investment in Canada by nonresidents. A similar interpretation applies to Canadian foreign direct investment in column 2.

Source: Statistics Canada, *Quarterly Estimates of the Canadian Balance of International Payments*, Cat. no. 67-001, Table 40, various issues.

Table B-2
Canadian Direct Investment Stock Abroad, by Area of Investment, 1975, 1980, and 1984

	1975		1980		1984	
	Can.$ millions	%	Can.$ millions	%	Can.$ millions	%
United States	5,559	52.8	16,386	63.4	29,932	71.7
Bahamas	147	1.4	260	1.0	173	0.4
Bermuda	462	4.4	948	3.6	1,235	3.0
Other North America	325	3.1	668	2.6	767	1.9
Total North America	*6,493*	*61.7*	*18,262*	*70.6*	*32,107*	*77.0*
South and Central America	*1,199*	*11.4*	*1,037*	*4.0*	*1,390*	*3.3*
United Kingdom	1,019	9.7	2,439	9.5	2,040	4.9
France	215	2.0	266	1.0	339	0.8
Netherlands	72	0.7	291	1.1	372	0.9
West Germany	156	1.5	251	1.0	271	0.7
Other Europe	403	3.8	1,139	4.4	1,647	3.9
Total Europe	*1,865*	*17.7*	*4,386*	*17.0*	*4,669*	*11.2*
South Africa	126	1.2	141	0.6	145	0.3
Other Africa	41	0.4	136	0.5	157	0.4
Total Africa	*167*	*1.6*	*277*	*1.1*	*302*	*0.7*
Japan	74	0.7	101	0.4	154	0.4
Indonesia	98	0.9	585	2.2	1,274	3.0
Other Asia	145	1.4	454	1.8	790	1.9
Total Asia	*317*	*3.0*	*1,140*	*4.4*	*2,218*	*5.3*
Australia	453	4.3	681	2.6	935	2.2
Other Australasia	32	0.3	70	0.3	104	0.3
Total Australasia	*485*	*4.6*	*751*	*2.9*	*1,039*	*2.5*
Total	*10,526*		*25,853*		*41,725*	

Sources: Statistics Canada, *Canada's International Investment Position 1979 and 1980*, Cat. no. 67-202, Table 4; revised 1980 and 1984 data provided by Statistics Canada, International and Financial Economics Division.

Table B-3
Canadian Investments in the United States, 1973–80

	Direct investment		Portfolio investment		
	Value (Can.$ millions)	% of total	Stocks (Can.$ millions)	Bonds	% of total
1973	$3,926	58.0%	$2,640	$203	42.0%
1974	4,789	61.6	2,765	282	38.4
1975	5,559	62.7	3,085	217	37.3
1976	6,092	62.6	3,435	285	37.4
1977	7,116	63.0	3,950	233	37.0
1978	8,965	64.3	4,680	305	35.7
1979	12,104	65.0	6,220	310	35.0
1980	16,395	69.4	6,840	375	30.6
Average		63.3			36.7

Note: Figures include the equity of nonresidents in assets abroad of Canadian companies but exclude the investments of insurance companies and banks held mainly against liabilities to nonresidents.

Source: Statistics Canada, *Canada's International Investment Position 1979 and 1980*, Cat. no. 67-202 (Ottawa, 1984), Table 2.

Table B-4
Canada's Balance of Payments, 1973–85
(Can.$ millions)

	Balance in long-term forms	Balance in short-term forms	Total net capital balance	Total current account balance	Net official monetary movements	Net direct investment (part of col. 1)	Net interest & dividends (part of col. 2)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1973	628	−1,203	−575	108	−467	60	−1,260
1974	1,041	443	1,484	−1,460	24	35	−1,553
1975	3,935	417	4,352	−4,757	−405	−190	−1,953
1976	8,021	−3,390	4,631	−4,109	522	−890	−2,829
1977	4,284	−1,371	2,913	−4,334	−1,421	−265	−3,841
1978	3,221	−1,603	1,618	−4,917	−3,299	−2,190	−4,905
1979	2,112	4,419	6,531	−4,840	1,908	−1,800	−5,396
1980	1,112	−1,494	−382	−1,114	−1,280	−2,350	−5,556
1981	175	7,105	7,280	−6,065	1,425	−11,300	−6,704
1982	8,314	−11,675	−3,361	2,665	−696	−2,075	−9,126
1983	1,819	−2,957	−1,138	1,686	548	−2,775	−8,954
1984	2,848	−6,490	−3,642	2,553	−1,089	−1,650	−11,264
1985	3,873	−2,577	1,296	−2,648	−1,352	−2,450	−12,812

Note: Figures for 1981–84 revised in May 1986.

Source: Statistics Canada, *Quarterly Estimates of the Canadian International Balance of Payments*, Cat. no. 67-001, various issues.

Table B-5
Distribution of Control of Capital in Canada's Nonfinancial Industries, 1974–82[a]
(percentage ownership)

	Manufacturing sector			Petroleum and natural gas sector			All nonfinancial industries		
	U.S.	Other	Canada	U.S.	Other	Canada	U.S.	Other	Canada
1974	43%	14%	43%	59%	16%	25%	26%	7%	67%
1975	42	13	45	59	15	26	26	7	67
1976	42	13	45	54	14	32	24	7	69
1977	42	12	46	51	13	36	24	6	70
1978	41	11	48	41	13	46	22	6	72
1979	39	12	49	40	13	47	22	6	72
1980	40	11	49	38	12	50	21	6	73
1981[b]	38	11	51	35	10	55	20	6	74
1982[b]	38	11	51	35	10	55	20	6	74

[a]Based on book value of long-term debt and equity (including retained earnings) employed in Canada at year ends.
[b]Pro forma projections.

Source: Statistics Canada, *Canada's International Investment Position 1979 and 1980*, Cat. no. 67-202 (Ottawa, 1984), Table 40.

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